

# Lock-In and Productive Innovations:

## Implications for Firm-to-Firm Innovation Pass-Through \*

Lucía Casal  
Cornell University

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### Abstract

Firms innovate to improve efficiency and reduce their costs of production (*productive* innovations) and to increase customer dependency through product customization (*lock-in* innovations). In this paper, I quantitatively study the macroeconomic implications of lock-in innovations for aggregate productivity and market power. I develop a theoretical framework that allows firms to invest in lock-in innovations by reducing product substitutability, while also nesting standard macroeconomic models of productive innovations. A key prediction of the model is that productive innovations by suppliers increase customer firms' sales by lowering input costs, while lock-in innovations decrease customer firms' sales by making the suppliers' products harder to substitute. I use this theoretical insight to identify the nature of innovation in the data and calibrate the model to the U.S. economy. Informed by the observed changes in the response of customer firms' sales to their suppliers' innovations, I find that the incidence of lock-in innovations among high-markup firms has increased significantly in the post-2000 period. Moreover, had incidence of lock-in innovations remained at pre-2000 levels, observed aggregate productivity increase would have been 30% higher, median markups would have stayed at pre-2000 levels, and the increase in markup dispersion would have been 83% lower.

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Email: [lc944@cornell.edu](mailto:lc944@cornell.edu), Cornell University, Department of Economics.

# 1 Introduction

Firms invest in innovations to enhance their productivity as well as to customize their products, making it more difficult for customers to switch to competitors. Productive innovations reduce the marginal cost of production or improve product quality (Aghion and Howitt, 1992). In contrast, innovations aimed at customization seek to create customer dependency, or a "lock-in" effect, making products more dissimilar or influencing their compatibility with other products (Farrell and Klemperer, 2007).

Lock-in strategies are particularly common in markets for technological products, where follow-on purchases of complementary products and services are necessary to maintain or improve the initial investment. Companies often derive significant profits from these aftermarket sales. The reliance on proprietary systems and product compatibility make it expensive for customers to adopt new alternative technologies. The original supplier then holds considerable market power, and can charge high prices for upgrades and related products. A notable example is Bell Atlantic's experience with AT&T. In the mid-1980s, Bell Atlantic invested \$3 billion in AT&T's state-of-the-art 5ESS digital switches to modernize its telephone network, choosing AT&T over rivals like Northern Telecom and Siemens. However, this investment locked Bell Atlantic into AT&T's proprietary system, forcing them to rely on AT&T for costly software upgrades and enhancements.<sup>1</sup> In this example, a productive innovation by AT&T (i.e., 5ESS digital switch) was followed up by successive lock-in innovations.

Both being highly productive and offering specialized products are important sources of market power (Pellegrino, 2023), and this accumulation of market power is central to firms' incentives to invest in innovation (Peters, 2020). While much of the literature has focused on productivity-enhancing innovations, the macroeconomic implications of lock-in innovations have been largely overlooked. In this paper, I study the macro implications of lock-in and productive innovations for aggregate productivity and aggregate market power. I first propose a new model that accommodates productive and lock-in innovations. Then I use the theory to identify the nature of innovations in the data. Finally, I calibrate the model to the U.S. economy and quantitatively assess the role of lock-in innovations for aggregate productivity and market power.

The economy is populated by a continuum of customer firms, each of which purchases inputs from a finite number of *supplier firms* and produces with a CRESH (Constant Ratio Elasticity of Substitution with Homotheticity) technology (Hanoch (1971)), i.e., a non-CES homothetic production function that allows for supplier-specific product substitutability. Customer firms imperfectly substitute across suppliers, and the degree of product substitutability varies across suppliers. Each supplier firm produces with a linear technology in labor and heterogeneous

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<sup>1</sup>Similarly, Apple first established the iPhone as a market leader and then introduced an ecosystem—including the App Store and iCloud—that locks users into their platform. Microsoft followed a similar strategy by integrating its Office suite with Windows, creating a seamless user experience that makes switching to other platforms difficult and costly.

labor productivity. Suppliers compete *à la* Bertrand, and choose prices to maximize profits each period. They also make two type of dynamic innovation decisions: they can invest in *productive* innovations, that increase their labor productivity; or they can invest in *lock-in* innovations, that reduce their product substitutability; or both.

An oligopolistic competition market structure induces endogenous markups by supplier firms. Markups are a function of a firms' market share —shaped by their productivity and substitutability—as well as their own substitutability, their competitors' substitutability, and the elasticity of substitution between customer firms. Consequently, there are two sources of market power: suppliers can charge high markups either because they are highly productive and/or because customers find it difficult to substitute away from them. Since markups directly influence profits, the model has a rich interplay between productivity and product substitutability in shaping the market value of the firm.

The model generalizes the workhorse model of heterogeneous firms and innovation by [Atkeson and Burstein \(2010\)](#) in three ways. First, I introduce production linkages, with supplier firms that are heterogeneous in productivity and in their firm-specific degree of product substitutability. Second, these suppliers compete oligopolistically to sell their products to other firms ([Aghion, Harris, Howitt and Vickers, 2001](#)).<sup>2</sup> Third, suppliers can invest in two types of innovations: productive innovations and lock-in innovations. I use the model to analyze firms' incentives to invest in these alternative innovations and to characterize the nature of innovation pass through from suppliers to their customer firms. The model nests different market structures and technology classes. This nesting ensures that all the mechanisms present in the canonical model of innovation with oligopolistic competition where suppliers differ in productivity, ([Aghion et al. \(2001\)](#)), are also present in the framework. A relevant particular case is when substitutability is identical for all suppliers that provide inputs to a given customer, in which case the model simplifies to the standard CES framework with oligopolistic competition and a non-unitary elasticity of substitution between customer firms, as in [Atkeson and Burstein \(2008\)](#).<sup>3</sup>

The model provides a key prediction on how innovation affects customer firms depending on the type of innovation undertaken by supplier firms. If suppliers invest in productive innovations, the sales of their customer firms increase. Productive innovations reduce the supplier's marginal costs of their products, resulting in lower input prices for the customer firm and higher sales. In contrast, if suppliers engage in lock-in innovations, the model predicts a decline in customer firms' sales. Lock-in innovations reduce product substitutability, enabling suppliers to charge higher prices. Customer firms suffer a decline in their total sales because

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<sup>2</sup>Customers could either be final consumers or other firms to which suppliers sell their products. In the former case, lock-in innovations would have direct implications for consumer welfare, while in the latter case, they would impact aggregate productivity. This paper focuses on a firm-to-firm context, which allows for a clear measurement of customer firms' responses to supplier innovations using firm-level balance sheet data. In contrast, measuring changes in consumer utility would be substantially more challenging.

<sup>3</sup>In [Atkeson and Burstein \(2008\)](#), *supplier firms* correspond to within-industry firms, while *customer firms* correspond to industry-level firms.

they are unable to pass on these increased input costs to their products due to intense competition in their own markets.

I use these model testable predictions to characterize the nature of suppliers' innovations in the data. I combine data on firm-to-firm linkages and firm financials from US Compustat Fundamentals, together with measures of product differentiation from the [Hoberg and Phillips \(2016\)](#) Index of Product Similarity. This index measures similarity of a product's firm compared to other firms based on text analysis of firm's product's descriptions. I further combine this information with innovation shocks from [Kogan, Papanikolaou, Seru and Stoffman \(2017\)](#), defined as the excess stock market return of patents assigned to a given firm. I begin by documenting the prevalence of lock-in innovations by calculating the share of innovations that lead to a decline in customer firms' sales. In the U.S., 20% of innovations are lock-in, with 80% of these undertaken by high-markup firms. I show that high-markup suppliers produce more differentiated products, consistent with [Pellegrino \(2023\)](#), and that this correlation has become stronger in the years after 2000. I also show that innovations by high-markup suppliers lead to a significant increase in product differentiation after 2000, but were associated with a significant decline in differentiation prior to 2000, while innovations by low-markup suppliers have no significant impact on differentiation in either period. Last, innovations by low-markup suppliers increase customer firms' sales, while innovations by high-markup suppliers lead to a decline in customer firms' sales after 2000 and an increase in customer firms' sales before 2000. These facts are novel to the literature. Through the lens of the model, my findings indicate that high-markup firms are more inclined to pursue lock-in innovations, particularly in recent years. In contrast, low-markup firms tend to invest in productive innovations.

I then study the implications of this shift in the prevalence of lock-in innovations for aggregate TFP and market power. I calibrate the model by simulating a panel of firms and running local projection regressions on the pass-through of innovation on customer sales in both the model and the data. This approach helps discipline key parameters related to the cost structures of lock-in and productive innovations, including the relationship between a firm's productivity gap relative to its competitors and the cost of each type of innovation. Using pre- and post-2000 data, I calibrate the model for two steady states: one for the post-2000 period and another for the pre-2000 period. Comparing these steady states, the model predicts a greater prevalence of lock-in innovations after 2000, driven largely by high-markup firms shifting their investment towards lock-in innovations.

Finally, I answer the question: How much of the observed changes in aggregate TFP, markup levels, and markup dispersion between the pre- and post-2000 periods can be explained by shifts in the composition of innovation? To answer this, I construct a counterfactual post-2000 economy that retains the lock-in innovation cost structure of the pre-2000 period. The results indicate that the observed increase aggregate productivity would have been 30% higher, median markups would have remained at pre-2000 levels, and the increase in markup dispersion would have been 83% lower.

**Related Literature.** This paper relates to several strands of literature.

First, this paper contributes to the literature that emphasizes the diverse nature of innovation. [Akcigit and Kerr \(2018\)](#) differentiate between internal and external innovations, where multi-product incumbents focus on internal innovations to improve existing products, while both new entrants and incumbents pursue external innovations to acquire new product lines. In both cases, innovation drives changes in productivity—either through new products or by enhancing the productivity of existing ones. [Argente, Baslandze, Hanley and Moreira \(2020\)](#) introduce the concept of protective versus productive innovations, with protective innovations being patents that never materialize into products. They examine how firms exploit the patent system by patenting without commercialization. My paper introduces a new type of innovation that is well-established in industrial organization literature: firms’ ability to create customized products that raise switching costs for customers. Moreover, I explore the strategic behavior of firms investing in both productive and lock-in innovations. In contrast, [Argente \*et al.\* \(2020\)](#) abstract from strategic behavior, and there is no effect on product substitution.

Second, this paper contributes to the literature on market power and innovation. [Aghion \*et al.\* \(2001\)](#) developed a seminal model of step-by-step innovations, where firms’ markups are endogenously determined by their investments in productivity. [Peters \(2020\)](#) built a theory of creative destruction with an endogenous distribution of markups to quantitatively examine the aggregate effects of market power on resource misallocation and [Cavenaile, Celik and Tian \(2019\)](#) constructed a Schumpeterian growth model with oligopolistic competition to explore the welfare implications of market power. In all these models, the sole endogenous driver of market power accumulation is firms’ investments in productivity. In contrast, my framework introduces a new source of market power accumulation: product substitutability, while maintaining the key features of these existing models. I generalize the model in [Atkeson and Burstein \(2010\)](#) to allow for an oligopolistic market structure that endogenously determines the distribution of markups. I show that without lock-in innovations, existing models cannot replicate the observed empirical patterns of innovation pass-through between supplier and customer firms. This highlights the importance of incorporating product substitutability to align the model predictions with empirical evidence. Productive innovations that lower marginal production costs naturally lead to reduced supplier prices, decreasing input costs for customer firms and boosting their sales. My quantitative model further predicts that high-markup suppliers will pass through a larger share of these cost reductions to their customers compared to low-markup suppliers, amplifying the positive impact on customer sales. In contrast, lock-in innovations enable suppliers to raise prices by creating dependencies that prevent customers from switching to alternatives. Since these higher input costs cannot be passed on to final goods producers, customer firms face increased costs, ultimately reducing their sales.<sup>4</sup>

Third, this paper introduces a new mechanism to the literature exploring the links between

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<sup>4</sup>A model where suppliers’ productive innovations enhance product quality would also lead to higher sales for customer firms. While higher-quality products come with higher prices, they attract greater demand, ultimately increasing the customer firm’s sales.

market concentration, productivity growth, and business dynamism in models of endogenous growth. [Akcigit and Ates \(2023\)](#) propose that declining imitation rates between leaders and followers have contributed to these trends, while [Olmstead-Rumsey \(2019\)](#) documents a fall in innovation efficiency among laggard firms over time. Other studies emphasize the role of intangible assets and information and communications technology (ICT) ([Aghion, Bergeaud, Boppart, Klenow and Li \(2023\)](#); [De Ridder \(2024\)](#)), the decline in the growth rate of the labor force ([Peters and Walsh \(2021\)](#)) and the decline in the interest rate ([Liu, Mian and Sufi \(2022\)](#)). This paper identifies the rise of lock-in innovations as a contributor to observed trends in markup dispersion and total factor productivity level.

Fourth, my paper contributes to the literature on the aggregate implications of customer capital accumulation and its relationship with market concentration, including studies that examine the role of investments in advertising ([Cavenaile and Roldan-Blanco, 2021](#); [Cavenaile, Celik, Perla and Roldan-Blanco, 2023](#); [Cavenaile, Celik, Roldan-Blanco and Tian, 2024](#); [Shen, 2023](#)), customer acquisition ([Ignaszak and Sedláček, 2022](#)) and brand reallocation ([Pearce and Wu, 2024](#)). In my framework, the reduction in product substitutability creates customer dependency, which can be interpreted as an alternative form of customer capital accumulation. My paper adds to this literature by introducing a new mechanism for generating customer dependency and analyzing the incentives firms have to invest in both lock-in and productive innovations in a framework where both types of innovations endogenously determine the firms' markups.

Lastly, my paper connects with industrial organization theories on switching costs and business strategies related to lock-in products ([Shapiro and Varian \(2000\)](#)). For example, [Farrell and Klemperer \(2007\)](#) and [Klemperer \(1987\)](#) propose microeconomic theories of optimal firm behavior in the presence of switching costs and explore their effects on market competition. However, these theories do not address the macroeconomic implications of lock-in innovations or how such investment decisions influence the endogenous accumulation of market power in an oligopolistic setting, which is the core focus of this paper.<sup>5</sup>

**Organization.** The paper is organized as follows: Section 2 presents the model of lock-in and productive innovations; Section 3 describes the data and empirical results; Section 4 presents the calibration and quantitative analysis on the aggregate implications of lock-in innovations and Section 5 concludes.

## 2 Model

Time is continuous. There is a representative household with preferences over final consumption who owns the firms in the market. Perfectly competitive firms produce the final good

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<sup>5</sup>[Kleshchelski and Vincent \(2009\)](#) examine the relationship between price rigidity and market share in a general equilibrium framework where customers face switching costs, and [Pellegrino \(2023\)](#) proposes a general equilibrium model of hedonic demand and studies the aggregate welfare implications of product differentiation in oligopolistic competition markets.



using inputs from a continuum of firms. Each of these firms produces using intermediate inputs purchased from two *supplier firms* that are imperfect substitutes and engage in oligopolistic competition to sell their products to the *customer firm*. Supplier firms are characterized by how productive they are, and also by how substitutable they are for the customer firm. Suppliers can invest in productivity-enhancing innovations or in "lock-in" innovations that make them less substitutable for the customer firm.

I use the model to (i) analyze supplier firms' incentives for productive and lock-in innovations, (ii) characterize how productive and lock-in innovation pass-through from supplier to customer firms and (iii) quantify the aggregate implications of lock-in innovations on aggregate productivity and market power.

## 2.1 Preferences and Technology

There is a representative household that consumes the final good, saves and supplies labor inelastically to maximize utility from consumption:

$$U_t = \int_0^\infty \exp(-\rho t) \ln C_t dt, \quad (1)$$

where  $\rho > 0$  represents the discount rate,  $C_t$  represents consumption at time  $t$ . The household faces a budget constraint:

$$P_t C_t + \dot{A}_t = W_t L_t + r_t A_t, \quad (2)$$

where  $L_t$  denotes labor and  $A_t$  denotes total assets at time  $t$ . Prices are given by  $P_t$  the price of final consumption good,  $r_t$  the interest rate, and  $W_t$  the wage rate, which I take to be the numeraire.

Each period  $t$ , the problem of the final good firm consists of choosing how much inputs to buy from each customer firm  $X_{ct}$  to maximize profits, taking prices as given:

$$\max_{X_{ct}} P_t Y_t - \int_0^1 P_{ct} X_{ct} dc \quad \text{s.t. equation (4)}. \quad (3)$$

Profit maximization yields the demand of customer firm  $c$ 's variety:  $X_{ct} = \left(\frac{P_{ct}}{P_t}\right)^{-\eta} Y_t$  with aggregate price index given by  $P_t = \left(\int_0^1 P_{ct}^{1-\eta} dc\right)^{\frac{1}{1-\eta}}$ .

Perfectly competitive firms produce the final good  $Y_t$  combining differentiated varieties  $X_{ct}$  according to:

$$Y_t = \int_0^1 \left( X_{ct}^{\frac{\eta-1}{\eta}} dc \right)^{\frac{\eta}{\eta-1}}, \quad (4)$$

where  $\eta > 1$  represents the elasticity of substitution between varieties.

Each variety  $c$  is produced combining intermediate inputs from two *supplier firms*  $s$  using a CRESH production technology, implicitly given by the relative size of each supplier:

$$\sum_s \left( \frac{x_{st}}{X_{ct}} \right)^{\frac{\gamma_{st}-1}{\gamma_{st}}} = 1, \quad (5)$$

where  $x_{st}$  denotes the output of supplier firm  $s$  at time  $t$ , and  $X_{ct}$  is the output of variety producer  $c$  at time  $t$ .<sup>6</sup> The variable  $\gamma_{st}$  represents supplier-specific substitutability, capturing the degree of product differentiation—i.e., the lower  $\gamma_{st}$ , the harder it is for variety producer  $c$  to substitute away from a supplier's product, indicating greater customer dependency to the supplier's product. Supplier substitutability evolves over time as a result of lock-in innovations.<sup>7</sup> Going forward, I will refer to the variety producers who buy inputs from supplier firms and sell their output to the final good producer as *customer* firms.

Each customer firm  $c$  decides the quantity of intermediate inputs to purchase from its two suppliers to maximize profits:

$$\max_{x_{st}, X_{ct}} P_{ct} X_{ct} - \sum_s p_{st} x_{st} \quad \text{s.t. equation (5)} \quad (6)$$

where  $p_{st}$  denotes the price charged by each supplier  $s$  at time  $t$ . The first order conditions for (6) yield a demand for each supplier firm  $s$ ,  $x_{st} = \left( \frac{p_{st}}{P_{ct} D_{ct}} \frac{\gamma_{st}}{\gamma_{st}-1} \right)^{-\gamma_{st}} X_{ct}$  with  $D_{ct} \equiv \left( \sum_s \frac{\gamma_{st}-1}{\gamma_{st}} \left( \frac{x_{st}}{X_{ct}} \right)^{\frac{\gamma_{st}-1}{\gamma_{st}}} \right)^{-1}$  a demand index.<sup>8</sup> A detailed derivation of the customer firm problem can be found in Appendix A.1.

For each customer firm, there are two imperfectly substitutable supplier firms that provide intermediate inputs to the customer firm, and produce according to a technology that is linear in labor  $l_{st}$ :

$$x_{st} = \exp(a_{st}) l_{st}, \quad (7)$$

where  $a_{st}$  denotes the labor log-productivity of firm  $s$  at time  $t$ . Supplier firms are heterogeneous in productivity  $a_{st}$  and substitutability  $\gamma_{st}$ , and engage in oligopolistic competition *à la* Bertrand. Supplier firms solve two problems: First, conditional on their productivity  $a_{st}$  and substitutability  $\gamma_{st}$ , they choose prices to maximize static profits each period  $t$ ; Second, given the profits realized in period  $t$ , they make productive and lock-in investment decisions to solve the dynamic problem of maximizing the firm's present discounted value. I first outline the static problem and then provide a detailed description of the innovation decisions.

**Static Pricing Decisions.** Each period  $t$ , suppliers set prices to maximize profits, subject to the demand from customer firm  $c$ . Since suppliers compete oligopolistically, they internalize how their allocation decisions affect the customer firm's production and prices. The resulting

<sup>6</sup>More generally, this production technology belongs to the Homothetic Demand with Implicit Additivity (HDIA) class (see Matsuyama (2017)), which can be written as  $\sum_s Y\left(\frac{x_{st}}{X_{ct}}\right) = 1$ , with  $Y(\cdot) : \mathbb{R}^+ \rightarrow \mathbb{R}^+$  strictly increasing, strictly concave function, that is twice continuously differentiable with  $Y(0) = 0$  and  $Y(1) = 1$ .

<sup>7</sup>In Hanoch (1971), substitutability parameters are factor-specific but do not vary with time.

<sup>8</sup>It is a property of this class of non-CES homothetic technologies to have the demand for a good depending on two relative prices,  $(p_{st}/P_{ct})$  and  $(p_{st}/D_{ct})$ . In the limiting case of CES technology where  $\gamma_{st} = \gamma$  for all  $s$ ,  $D_c = \frac{\gamma}{\gamma-1}$ , which implies  $p_{st} = \left(\frac{x_{st}}{X_{ct}}\right)^{\frac{-1}{\gamma-1}} P_{ct}$ , i.e., there is only one relevant aggregate price given by the CES ideal price index  $P_{ct}$ . See Matsuyama (2017) for more details.



profit maximization problem is then:

$$\begin{aligned} \pi_{st} &= \max_{p_{st}} \left\{ p_{st} x_{st} - W \frac{x_{st}}{a_{st}} \right\} \\ \text{s.t. } x_{st} &= \left( \frac{p_{st}}{P_{ct}(p_{st}) D_{ct}(p_{st}) \gamma_{st} - 1} \right)^{-\gamma_{st}} X_{ct}(p_{st}), \end{aligned} \quad (8)$$

where the prices and quantities of the customer firm  $P_{ct}(p_{st})$ ,  $D_{ct}(p_{st})$  and  $X_{ct}(p_{st})$  as a function of the supplier's pricing decisions  $p_{st}$  reflects the strategic behavior given by the oligopolistic market structure. The resulting optimal pricing decision by each supplier firm  $s$  is given by a markup  $\mu_{st}$  over marginal cost  $p_{st} = \frac{\vartheta_{st}}{\vartheta_{st}-1} \frac{W_t}{\exp a_{st}}$ , where  $\vartheta_{st}$  denotes the firm's  $s$  elasticity of demand in period  $t$ , characterized later in section 2.2.1.

## Innovation

Suppliers can invest in *productive* innovations to increase productivity  $a_{st}$  or *lock-in* innovations to reduce their product substitutability  $\gamma_{st}$ .

**Productive Innovations.** Suppliers undertake *productive* innovations to retain or achieve market leadership by increasing their productivity. When a supplier invests in productive innovations in period  $t$ , there is a probability  $i_{st}$  that her productivity increases in period  $t + \Delta$  by a proportional factor  $\lambda > 0$ , such that  $a_{st+\Delta t} = a_{st} + \lambda$ , and a probability  $(1 - i_{st})$ , that her productivity decreases, so that  $a_{st+\Delta t} = a_{st} - \lambda$ .

A supplier generates a Poisson arrival rate of productive innovations of  $i_{st}$  by employing  $h_{st}^i$  innovation workers, according to the function  $i_{st} = \left( \frac{1}{\exp(a_{st}^{\psi_s} - a_{-st}^{\psi_{-s}})} \right)^\psi \left( \phi \frac{h_{st}^i}{\alpha} \right)^{\frac{1}{\phi}}$ , where  $\phi > 1$  represents the inverse elasticity of productive innovations with respect to innovation workers,  $\psi_s$  and  $\psi_{-s}$  govern the cost-elasticity of productive innovations to a supplier's own productivity and the productivity of its competitor, and  $\alpha > 0$  is a scale parameter. Given the wage rate in the economy  $W_t$ , the cost of productive innovations is

$$\mathcal{C}(i_{st}) \equiv \alpha \frac{(\exp(a_{st}^{\psi_s} - a_{-st}^{\psi_{-s}})^\psi i_{st})^\phi}{\phi} W_t. \quad (9)$$

For  $\psi_s > 0$ , the cost of productive innovation is increasing in the supplier's productivity  $a_{st}$ , reflecting the idea that more advanced technologies are more costly or difficult to improve (Akcigit and Kerr (2018), Atkeson and Burstein (2010)).

**Lock-In Innovations.** Suppliers can also choose to invest in *lock-in* innovations to reduce their product substitutability, making it more difficult for customers to switch to other suppliers, i.e. locking them in. A successful lock-in innovation in period  $t$  decreases the supplier's substitutability in period  $t + \Delta$  by a proportional factor  $\delta > 0$ , such that  $\gamma_{s,t+\Delta} = (1 - \delta)\gamma_{s,t}$ . A supplier generates a Poisson arrival rate of productive innovations of  $z_{st}$  by employing  $h_{st}^z$  innovation workers, according to the function  $z_{st} = \left( \frac{1}{\exp(a_{st}^{\tilde{\psi}_s} - a_{-st}^{\tilde{\psi}_{-s}})} \right)^{\tilde{\psi}} \left( \tilde{\phi} \frac{h_{st}^z}{\tilde{\alpha}} \right)^{\frac{1}{\tilde{\phi}}}$ , with  $\tilde{\phi} > 1$  the inverse elasticity of lock-in innovations with respect to innovation workers and  $\tilde{\alpha} > 0$  a scale parameter. Parameters  $\tilde{\psi}_s$  and  $\tilde{\psi}_{-s}$  govern the elasticity of the cost of lock-in innovations with

respect to a supplier's productivity gap relative to its competitor  $\exp(a_{st}^{\tilde{\psi}} - a_{-st}^{\tilde{\psi}})$ , which in the quantitative application will play an important role in matching the empirical facts on the relationship between market power and lock-in innovations. The cost of lock-in innovations is therefore given by

$$\mathcal{C}(z_{st}) \equiv \tilde{\alpha} \frac{(\exp(a_{st}^{\tilde{\psi}} - a_{-st}^{\tilde{\psi}})^{\tilde{\psi}} z_{st})^{\tilde{\phi}}}{\tilde{\phi}} W_t. \quad (10)$$

**Dynamic Innovation Decisions.** The payoff-relevant state variables for a supplier firm  $s$  are its current productivity level  $a_{s,t}$ , its current substitutability level  $\gamma_{s,t}$ , and the productivity and substitutability levels of its competitor, denoted by  $a_{-s,t}$  and  $\gamma_{-s,t}$ . The stock market value  $V_{st}(a_s, a_{-s}, \gamma_s, \gamma_{-s})$  of supplier  $s$  at state  $(a_s, a_{-s}, \gamma_s, \gamma_{-s})$  is given by:

$$\begin{aligned} \rho V_t(a_s, a_{-s}, \gamma_s, \gamma_{-s}) = & \pi_t(a_s, a_{-s}, \gamma_s, \gamma_{-s}) \\ & + \max_{i_{st}} \left\{ \underbrace{[V_t(a_s + \lambda, a_{-s}, \gamma_s, \gamma_{-s}) - V_t(a_s, a_{-s}, \gamma_s, \gamma_{-s})]}_{\text{successful productive innovation}} \right. \\ & + \underbrace{(1 - i_{st}) [V_t(a_s - \lambda, a_{-s}, \gamma_s, \gamma_{-s}) - V_t(a_s, a_{-s}, \gamma_s, \gamma_{-s})]}_{\text{unsuccessful productive innovation}} - \underbrace{\mathcal{C}(z_{st})}_{\text{productive innov. cost}} \left. \right\} \\ & + \max_{z_{st}} \left\{ \underbrace{[V_t(a_s, a_{-s}, \gamma_s(1 - \delta), \gamma_{-s}) - V_t(a_s, a_{-s}, \gamma_s, \gamma_{-s})]}_{\text{successful lock-in innovation}} - \underbrace{\mathcal{C}(i_{st})}_{\text{lock-in innov. cost}} \right\} \\ & + \underbrace{i_{-st} [V_t(a_s, a_{-s} + \lambda, \gamma_s, \gamma_{-s}) - V_t(a_s, a_{-s}, \gamma_s, \gamma_{-s})]}_{\text{competitor's successful productive innovation}} \\ & + \underbrace{(1 - i_{-st}) [V_t(a_s, a_{-s} - \lambda, \gamma_s, \gamma_{-s}) - V_t(a_s, a_{-s}, \gamma_s, \gamma_{-s})]}_{\text{competitor's unsuccessful productive innovation}} \\ & + \underbrace{z_{-st} [V_t(a_s, a_{-s}, \gamma_s, \gamma_{-s}(1 - \delta)) - V_t(a_s, a_{-s}, \gamma_s, \gamma_{-s})]}_{\text{competitor's successful lock-in innovation}} \\ & + \underbrace{\kappa [V_t(a_s, a_{-s}, \tilde{\gamma}, \tilde{\gamma}) - V_t(a_s, a_{-s}, \gamma_s, \gamma_{-s})]}_{\text{market restart}}. \end{aligned} \quad (11)$$

The first line on the right-hand side of expression (11) represents the operating profits in period  $t$ . The second line captures the increase in the value of the firm as a result of a successful productive innovation that enhances its productivity by proportional factor  $\lambda$ . The third line accounts for the decrease in firm value if the productive innovation fails, reducing productivity by the same factor  $\lambda$ , net of the cost of investing in productive innovations given by equation 9. The fourth line reflects changes in the value of the firm given by a successful lock-in innovation that reduces the firm's product substitutability by a proportional factor  $\delta$ , net of the cost of investing in lock-in innovations given by equation 10. Given that supplier firms act strategically, they internalize how competitors' actions influence their own value. Accordingly, the fifth and sixth lines capture the impact on firm value from a competitor's successful or unsuccessful productive innovation, respectively, while the seventh line reflects changes in value due to a competitor's successful lock-in innovation. Finally, with exogenous probability  $\kappa$ , the market resets in terms of substitutability, returning all suppliers to the highest possible level of substitutability. This reset mechanism captures external shocks that push firms into a neck-and-neck

position in terms of substitutability (e.g., the entry of new firms that induce competitive pressure over incumbents) and ensures the existence of a stationary distribution of firms.

## 2.2 Equilibrium

**Market clearing.** The labor market clearing condition requires that the aggregate supply of labor  $L = 1$  equalizes the sum of supplier firms' production labor demand and productive and lock-in innovations labor demand, such that  $\int_0^1 [l_{st} + l_{-st} + h_{st}^i + h_{-st}^i + h_{st}^z + h_{-st}^z] ds = 1$ , with optimal demand of innovation labor given by  $h_{st}^i = \alpha \frac{(\exp(a_{st})^\psi i_{st})^\phi}{\phi}$  and  $h_{st}^z = \tilde{\alpha} \frac{(\exp(a_{st}-a_{-st})^{\tilde{\psi}} z_{st})^{\tilde{\phi}}}{\tilde{\phi}}$ . The goods market clearing requires that aggregate output equalizes aggregate consumption, i.e.,  $Y_t = C_t$ .

**Stationary Distribution of Firms.** Denote by  $\mu_t(a_s, a_{-s}, \gamma_s, \gamma_{-s})$  the measure of firms in period  $t$  and state  $(a_s, a_{-s}, \gamma_s, \gamma_{-s})$ . The transition path of  $\mu_t$  for an interior state in which  $\underline{\gamma} < (\gamma_s, \gamma_{-s}) < \bar{\gamma}$  and  $\underline{a} < (a_s, a_{-s}) < \bar{a}$  is given by:

$$\begin{aligned} \frac{\mu_{t+\Delta}(a_s, a_{-s}, \gamma_s, \gamma_{-s}) - \mu_t(a_s, a_{-s}, \gamma_s, \gamma_{-s})}{\Delta t} &= \underbrace{i_{st}\mu_t(a_s - \lambda, a_{-s}, \gamma_s, \gamma_{-s}) + i_{-st}\mu_t(a_s, a_{-s} - \lambda, \gamma_s, \gamma_{-s})}_{\text{inflows from successful productive innovations}} \\ &+ \underbrace{(1 - i_{st})\mu_t(a_s + \lambda, a_{-s}, \gamma_s, \gamma_{-s}) + (1 - i_{-st})\mu_t(a_s, a_{-s} + \lambda, \gamma_s, \gamma_{-s})}_{\text{inflows from unsuccessful productive innovations}} \\ &+ \underbrace{z_{st}\mu_t(a_s, a_{-s}, \gamma_s(1 + \delta), \gamma_{-s}) + z_{-st}\mu_t(a_s, a_{-s}, \gamma_s, \gamma_{-s}(1 + \delta))}_{\text{inflows from successful lock-in innovations}} \\ &- \underbrace{(2 + z_{st} + z_{-st} + \kappa)\mu_t(a_s, a_{-s}, \gamma_s, \gamma_{-s})}_{\text{outflows}} + o(\Delta t)/\Delta t. \end{aligned} \quad (12)$$

The first line on the right-hand side represents inflows to the state  $(a_s, a_{-s}, \gamma_s, \gamma_{-s})$  resulting from successful productive innovations by firms that are one  $\lambda$  step below in productivity. In contrast, the second line corresponds to inflows from unsuccessful productive innovations by firms that are one  $\lambda$  step above in productivity. The third line captures inflows from successful lock-in innovations by firms that are one  $\delta$  step above in product substitutability. Outflows occur either due to successful or unsuccessful productive innovations, or from successful lock-in innovations or from the market reset experienced by firms in the state  $(a_s, a_{-s}, \gamma_s, \gamma_{-s})$ . The term  $o(\Delta t)/\Delta t$  represents second-order moments that capture the probability of two or more innovations happening within the interval  $\Delta$ , and satisfies  $\lim_{\Delta t \rightarrow 0} o(\Delta t)/\Delta t = 0$ . In a stationary equilibrium, the mass of supplier firms at each state must be time invariant. This implies that the measure of firms entering and leaving each state must be equal at every instant, ensuring  $\mu_{t+\Delta}(a_s, a_{-s}, \gamma_s, \gamma_{-s}) = \mu_t(a_s, a_{-s}, \gamma_s, \gamma_{-s})$ .

**Definition 1. Equilibrium.** A dynamic general equilibrium in this economy is a sequence of allocations  $\{r_t, P_t, P_{ct}, p_{jt}, x_{jt}, l_{jt}, h_{jt}^i, h_{jt}^z, i_{jt}, z_{jt}, X_{ct}, L_t, Y_t, C_t, \mu_t\}_{j \in \{s, -s\}; c \in [0, 1]}^{t \in [0, \infty]}$  such that (i) Supplier firms prices  $p_{st}$  solve the static profit maximization 8, (ii) innovation decisions  $i_{st}, z_{st}$  solve the dynamic problem 11; (iii) Customer firms quantities  $X_{ct}$  and prices  $P_{ct}$  solve the profit maximization problem 6; (iv) aggregate output  $Y_t$  is derived from the profit maximization problem of the Final Good producer; (iv)

The real interest rate  $r_t$  is given by the Euler equation of the household; (v) Labor market clears, equation 2.2; (vii) Final goods aggregate price index  $P_t$  clears the good markets,  $Y_t = C_t$  and (viii) the measure of firms  $\mu_t$  evolve according to 12 consistent with firms' innovation decisions.

### 2.2.1 Properties

In this section, I discuss the equilibrium implications of the model, with a focus on its novel insights about the trade-off between firm productivity and product substitutability across key dimensions including markups, market share, and profits.

#### Trade-off between Productivity and Product Substitutability

##### Proposition 1. Equilibrium elasticity of demand.

Let  $\epsilon_{X_{ct}, p_{st}} \equiv \frac{d \ln X_{ct}}{d \ln p_{st}}$  be the elasticity of customer's quantities  $X_{ct}$  with respect to changes in supplier's price  $p_{st}$ , and  $\epsilon_{P_{ct} D_{ct}, p_{st}} \equiv \frac{d \ln P_{ct} D_{ct}}{d \ln p_{st}}$  the elasticity of customer's adjusted price index  $P_{ct} D_{ct}$  with respect to changes in supplier's price. Under Bertrand oligopolistic competition between suppliers, supplier's elasticity of demand  $\vartheta_{st}$  is given by:

$$\vartheta_{st}^{\text{Bertrand}} = \underbrace{\underbrace{\gamma_{st}}_{\text{monopolistic competition}} (1 - \epsilon_{P_{ct} D_{ct}, p_{st}})}_{\text{oligopolistic competition}} + \epsilon_{X_{ct}, p_{st}}.$$

See Proof in Appendix A.2.1.<sup>9</sup>

Proposition 1 characterizes the elasticity of demand for supplier firms in equilibrium when they compete on prices in an oligopolistic market and customer firms use CRESH production technology. In equilibrium, this elasticity of demand depends on the slope of the demand curve, which is captured by the time-varying, supplier-specific substitutability  $\gamma_{s,t}$  in the CRESH framework. This would represent the elasticity of demand if suppliers were competing in a monopolistic market, as discussed further below. However, in oligopolistic competition, suppliers internalize the effect of their pricing decisions on customer allocations. As a result, a supplier's elasticity of demand also depends on two key factors: the elasticity  $\epsilon_{P_c D_c, p_s}$  of the customer's adjusted price index  $P_c D_c$  with respect to the supplier's price  $p_s$ , and the elasticity  $\epsilon_{X_c, p_s}$  of the customer's production  $X_c$  with respect to the supplier's price.<sup>10</sup>

The elasticity of customer allocations to supplier prices, which determine the supplier's equilibrium elasticity of demand (see Proposition 1), can be expressed as functions of the supplier's market share, as demonstrated in the following corollary.

**Corollary 1.** The equilibrium elasticity of demand of supplier firms  $s$  in each period  $t$  can be expressed as a function of the market share of supplier  $s$ ,  $S_{st}(a_{st}, \gamma_{st}) \equiv \frac{p_{st} X_{st}}{P_{ct} X_{ct}}$ , according to:

$$\vartheta_{st}^{\text{Bertrand}} = \gamma_{st} \left( 1 - \frac{\gamma_{st} S_{st}(a_{st}, \gamma_{st})}{\sum_s \gamma_{st} S_{st}(a_{st}, \gamma_{st})} \right) + \eta S_{st}(a_{st}, \gamma_{st}) \quad (13)$$

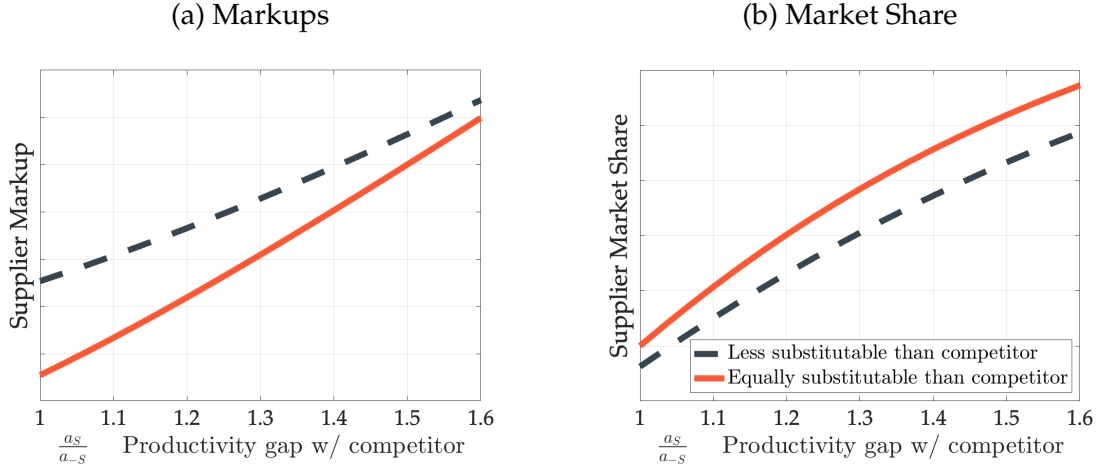
<sup>9</sup>The Cournot competition version of Proposition 1 is stated in Appendix A.2.1.

<sup>10</sup>If suppliers compete in quantities (Cournot), the elasticity of demand is a function of the elasticity  $\epsilon_{X_c, x_s}$  of customer's production  $X_c$  to supplier's quantities  $x_s$ , the elasticity  $\epsilon_{P_c, x_s}$  of customer's price  $P_c$  to supplier's quantities, and the elasticity  $\epsilon_{D_c, x_s}$  of customer's demand aggregator  $D_c$  to supplier quantities. See Appendix A.2.1 for details.

See Proof in Appendix A.2.2.

Corollary 1 establishes that the supplier's elasticity of demand is influenced by its product substitutability ( $\gamma_s$ ), the elasticity of substitution between customer firms ( $\eta$ ), its market share ( $S(a_s, \gamma_s)$ ), and the overall distribution of market shares and product differentiation among suppliers ( $\sum_s \gamma_s S_s(a_s, \gamma_s)$ ). In this model, a supplier's market share is a function of both its productivity and substitutability, as detailed below.

**Figure 1: Supplier Firm: Markups and Market Share**



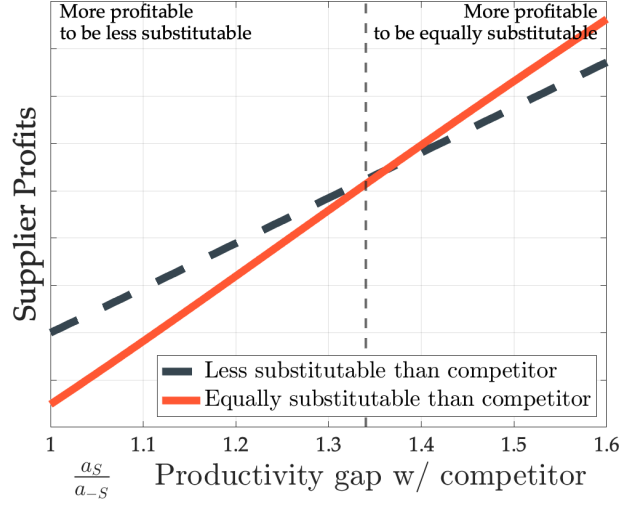
Notes: markups and market shares for when supplier firms are equally substitutable ( $\gamma_s = \gamma_{-s}$ ) and for when the supplier  $s$  is half as substitutable as its competitor ( $\gamma_s = 0.5\gamma_{-s}$ ). Markups are derived using the elasticity of demand from Corollary 1.

Figure 1 panel (a) illustrates the relationship between a supplier's markup and its productivity gap relative to its competitor. The green line represents the case where both suppliers are equally substitutable, corresponding to a customer CES technology where  $\gamma_s = \gamma_{-s}$ . In contrast, the pink line shows the case where the supplier is less substitutable than its competitor, reflecting a customer CRESH technology with  $\gamma_s < \gamma_{-s}$ . There are two key insights. First, the solid line indicates that with equal substitutability, a larger productivity gap between a firm and its competitor leads to a higher markup. This prediction aligns with standard models of oligopolistic competition where firms differ in productivity. However, when product substitutability is introduced as a second dimension of heterogeneity, a firm that is less substitutable relative to its competitor can charge a higher markup for any given productivity gap (dashed line). Thus, the model features two sources to market power: firms can secure high markups either by outperforming their competitors in productivity or by being less substitutable. Consequently, firms' dynamic decisions regarding productive and lock-in innovations, which I describe in the next section, will shape their accumulation of market power over time.

Although higher productivity and lower substitutability both lead to higher markups, they differ in how they affect a firm's market share, as illustrated in Figure 1 panel (b). When the two suppliers are equally substitutable, a larger productivity gap results in a higher market share, consistent with Aghion *et al.* (2001). However, when a supplier is less substitutable than its competitor, it captures a smaller market share for any given level of the productivity gap. The relationship between profits, productivity, and product substitutability, as discussed next,

will be shaped by these trade-offs.

**Figure 2: Supplier Firm: Profits**



Notes: equilibrium supplier profits for when supplier firms are equally substitutable ( $\gamma_s = \gamma_{-s}$ ) and for when the supplier  $s$  is half as substitutable as its competitor ( $\gamma_s = 0.5\gamma_{-s}$ ).

Figure 2 illustrates the relationship between a supplier's profits, its productivity gap relative to its competitor, and its product substitutability. The profits of a supplier with productivity  $a_s$ , product substitutability  $\gamma_s$ , that competes with another supplier with productivity  $a_{-s}$  and product substitutability  $\gamma_{-s}$  are given by  $\pi_t(a_s, a_{-s}, \gamma_s, \gamma_{-s}) = p_{st}x_{st} - W_t l_{st}$ . As before, the solid line represents the case where the firm is equally substitutable as its competitor, while the dashed line represents the scenario where the firm is less substitutable. The figure highlights the trade-off between product substitutability and productivity in determining profits. When a firm is moderately more productive than its competitor, capturing a niche market by being less substitutable is more profitable than being equally substitutable. However, once the firm becomes significantly more productive, to the point where the competitor no longer poses a threat, it becomes more profitable to be equally substitutable and capture a larger share of the market.

### Mapping to Standard Models

A key feature of the model is its ability to encompass both monopolistic and oligopolistic competition, as well as CES and non-CES homothetic demand systems. Table 1 illustrates this versatility by mapping the CRESH version of the model, with oligopolistic competition used in this paper, to the canonical CES models with oligopolistic competition and to a monopolistic competition structure. The first column of the table outlines the demand or technology class, either CRESH or CES. The second column presents the functional form of the homothetic aggregator that determines the customer firm's production technology, described in the third column. The definition of the aggregator remains independent of the market structure in which firms operate. In the CRESH case, as explained before when describing the problem of the customer firm, the homothetic aggregator is  $(\frac{x_s}{X_c})^{\frac{\gamma_{s,t}-1}{\gamma_{s,t}}}$ , leading to a customer production



technology implicitly defined by condition  $\sum_s \left(\frac{x_s}{X_c}\right)^{\frac{\gamma_{s,t}-1}{\gamma_{s,t}}} = 1$ . In the CES case, the homothetic aggregator is  $\left(\frac{x_{st}}{X_{ct}}\right)^{\frac{\gamma-1}{\gamma}}$ , which results in a customer firm technology analytically derived as the standard CES production function:  $X_{ct} = \left(\sum_s x_{st}^{\frac{\gamma-1}{\gamma}}\right)^{\frac{\gamma}{\gamma-1}}$ .

The last two columns of the table use Proposition 1 to outline the equilibrium elasticity of demand for a supplier firm  $s$  under both monopolistic (fourth column) and oligopolistic (last column) competition. In a monopolistic market structure with CRESH technology, the elasticity of demand is determined by the supplier-specific, time-varying substitutability  $\gamma_{s,t}$ . For monopolistic competition with CES technology, the elasticity of demand is constant and equal to the common elasticity of substitution between suppliers, denoted by  $\gamma$ . Under oligopolistic competition with CRESH technology, the elasticity of demand follows Corollary 1. In this case, the larger a supplier's market share, the more its demand elasticity—and therefore its prices and profits—are influenced by the elasticity of substitution between customers. Conversely, the smaller the market share, the more its demand elasticity is driven by its own product substitutability. The key distinction between this model and the canonical CES models with oligopolistic competition lies in the supplier-specific, time-varying substitutability, as opposed to the common substitutability across firms in the CES case. In fact, when  $\gamma_{s,t} = \gamma$  for all  $s$ , the model reverts to [Atkeson and Burstein \(2008\)](#), where demand elasticity smoothly adjusts with market share, weighted by the elasticity of substitution across customers and the common elasticity of substitution across suppliers.

**Table 1: Model Applications**

| Technology class | Homothetic aggregator  | Customer technology   | Supplier elasticity of demand $\vartheta_s$ |   |
|------------------|--|---|---|---|
|                  |  |   | Monopolistic                                | Oligopolistic   |
| CRESH            | $\left(\frac{x_s}{X_c}\right)^{\frac{\gamma_{st}-1}{\gamma_{st}}}$ | $\sum_s \left(\frac{x_s}{X_c}\right)^{\frac{\gamma_{st}-1}{\gamma_{st}}} = 1$             | $\gamma_{st}$                               | This paper<br>$\gamma_s \left(1 - \frac{\gamma_s S_{st}(a_{st}, \gamma_{st})}{\sum_s \gamma_s S_{st}(a_{st}, \gamma_{st})}\right) + \eta S_{st}(a_{st}, \gamma_{st})$ |
| CES              | $\left(\frac{x_{st}}{X_{ct}}\right)^{\frac{\gamma-1}{\gamma}}$     | $X_{ct} = \left(\sum_s x_{st}^{\frac{\gamma-1}{\gamma}}\right)^{\frac{\gamma}{\gamma-1}}$ | $\gamma$                                    | <a href="#">Atkeson and Burstein (2008)</a><br>$\gamma (1 - S_{st}(a_{st})) + \eta S_{st}(a_{st})$  |

Notes: Model application to CRESH and CES technology, under monopolistic and oligopolistic competition between supplier firms. See Cournot competition version and Kimball demand application in Appendix Table 10.

## Innovation Pass-Through from Supplier to Customer Firms

An advantage of this setup is that it allows for the analysis of how changes in the productivity or substitutability of supplier firms differently impact customer firms. I define *innovation pass-through* as the transmission of changes in a supplier's productivity ( $a_s$ ) or substitutability ( $\gamma_s$ ) to the sales of customer firms. This definition is particularly useful because, in the data, I have access to customer firms' balance sheets, including their sales, but I do not observe prices and

quantities separately. In the model, a total differentiation of the customer firm's sales with respect to changes in the supplier's productivity and substitutability yields:

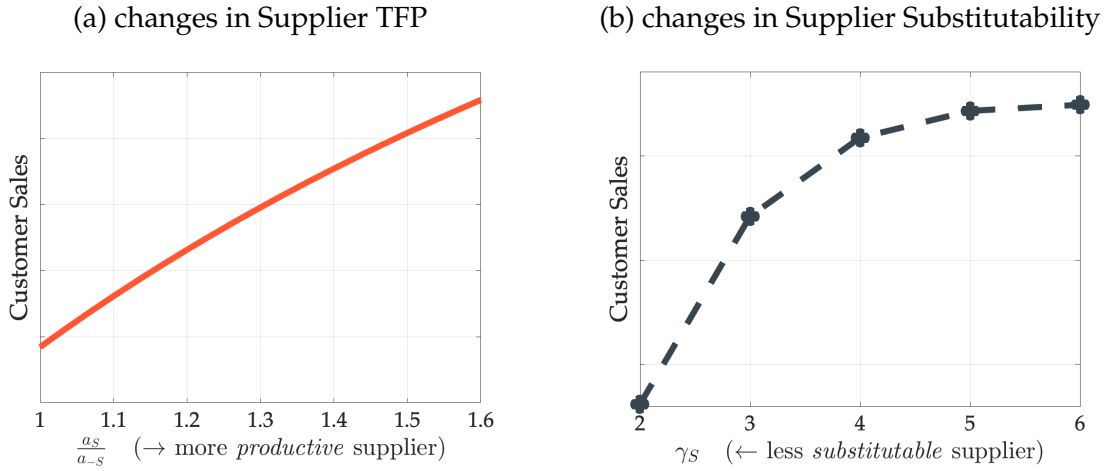
$$d\log P_c X_c = \underbrace{(1-\eta)}_{<0} \left[ \underbrace{\frac{\partial \log p_s}{\partial a_s}}_{<0} S_s da_s + \underbrace{\frac{\partial \log p_s}{\partial (1/\gamma_s)}}_{>0} S_s d(1/\gamma_s) \right] \quad (14)$$

Equation 14 shows that the impact of changes in a supplier firm's productivity or substitutability on its customer's sales is driven by how the supplier's price adjusts in response to these changes, weighted by the supplier's market share in the customer's sales.

On one hand, an increase in the supplier's productivity reduces its marginal cost, leading to a lower price charged to the customer firm. This decrease in the supplier's price, in turn, reduces the marginal cost for the customer firm, resulting in an increase in the customer firm's sales (see Figure 3, panel (a)). On the other hand, when substitutability decreases, the supplier can charge higher prices for a given level of productivity. The resulting increase in the supplier's price raises the customer firm's marginal cost, which it cannot pass on to final good producers due to strong competition from other customer firms. The higher production costs and limited ability to pass them on lead to a reduction in the customer firm's sales (see Figure 3, panel (b)).

These opposing effects of changes in supplier productivity and substitutability on customer sales provide a testable implication, which I will apply in the empirical analysis to infer the types of innovations that suppliers are implementing.

**Figure 3:** Comparative Statics: Changes in Customer Sales after...



Notes: change in customer sales after changes in suppliers' productivity  $a_s$ , keeping competitor's productivity  $a_{-s}$  fixed (panel (a)), or after changes suppliers' product substitutability  $\gamma_s$  (panel (b)).

### 3 Lock-in and Productive Innovations in the Data

This section presents empirical findings on innovation, market power and product differentiation, and innovation pass-through from supplier to customer firms. I start by describing the data sources, followed by the empirical strategy and results.

### 3.1 Data description

I combine firm-level estimates of markups, product differentiation and innovation shocks, together with supplier-customer firm linkages and balance sheet information.

**Firm's balance sheet data.** I obtain firm-level financial data from Compustat Fundamentals, a panel of publicly listed U.S. firms, which I access through the Wharton Research Data Services (WRDS) platform. Compustat offers two main advantages for this study: (i) it includes rich financial data for a long panel of firms, starting in 1978, which allows to use within-firm variation, and also to exploit variation before and after year 2000s when the U.S. economy experienced remarkable changes in market power and business dynamism, as discussed below; (ii) it allows to match firm-identifiers to the firm linkages dataset described below, obtaining balance-sheet information for both supplier and customer firms.<sup>11</sup>

**Markups estimation.** I estimate markups at the firm level by production function estimation as in [De Loecker and Warzynski \(2012\)](#) and [De Loecker, Eeckhout and Unger \(2020\)](#), using data on sales and variable input expenditures from Compustat, together with estimates of output elasticity.<sup>12</sup> For the rest of the analysis, I define *high markup suppliers* as those supplier firms whose markups lie within the 80th or higher percentiles of the markup distribution, and define *low markup suppliers* as the rest of supplier firms. However, results are robust to alternative thresholds (60th, 70th, or 90th percentile or higher).<sup>13</sup>

**Innovation shocks.** I use the market value of patents issued by a public firms in U.S., estimated by [Kogan et al. \(2017\)](#) as firm-level measure of innovation shocks. They estimate the excess stock market return of patents assigned to a given firm in a window around patent approval dates. The main advantage of this measure for my study is that it provides a private dollar-value of patents which can be mapped to the stock market value of a firm, which drives firms' innovation decisions in the model. Moreover, the excess stock market return of patents capture unexpected shocks.

**Product differentiation.** I use the product similarity measure developed by [Hoberg and Phillips \(2016\)](#) as an estimate of firm-level product differentiation. They created a publicly available database of product similarity scores for nearly all publicly traded U.S. firms, which has become a widely used resource in both finance and industrial organization research. Their methodology employs natural language processing techniques to analyze the content of an-

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<sup>11</sup>The main disadvantage of Compustat dataset is that it does not include privately held firms. In the Data Appendix, I provide robustness checks for the empirical patterns presented below using a broader sample of firms from FACTSET dataset, which includes privately held ones.

<sup>12</sup>An alternative method to estimate markups, referred to as the demand approach, estimates marginal costs using data on prices and quantities. However, because Compustat Fundamentals lack firm-level price data, this approach is not applicable. See [Nevo \(2001\)](#), [Berry, Levinsohn and Pakes \(1995\)](#) and [Goeree \(2008\)](#) for well-known industry studies.

<sup>13</sup>[Bond, Hashemi, Kaplan and Zoch \(2021\)](#) examine the challenges of identifying and estimating markups when firm-level output prices are not available. They suggest that a viable alternative is to compare mean markups across groups of firms, as long as one is willing to assume that production function elasticities do not vary systematically with firm characteristics (in this context, markup status).

nual 10-K filings submitted to the U.S. Securities and Exchange Commission (SEC), producing product similarity scores that vary annually over time. The 10-K is an annual regulatory report required of publicly traded companies in the U.S., and Item 1 of the report contains detailed descriptions of the firm’s products and services. [Hoberg and Phillips \(2016\)](#) utilize these textual descriptions to construct a dataset of product cosine similarities, capturing the extent of similarity in product characteristics across firms. For my analysis, I use the *Total Similarity* index, which is calculated as the sum of the pairwise similarities between a given firm and all other firms in the sample within a given year. Henceforth, I will refer to this measure as *HP Similarity Score*. Intuitively, a lower total similarity score for a firm in a given year indicates higher product differentiation or greater uniqueness of its products relative to other firms.

**Supplier-customer firm linkages.** I use the dataset constructed by [Barrot and Sauvagnat \(2016\)](#) to obtain production linkages between supplier and customer firms. To identify the linkages, they rely on the obligation that publicly listed U.S. firms have to report the identity of any customer representing more than 10% of their total sales, under regulation Statement of Financial Accounting Standards (SFAS) No.131. Customer firms in this dataset are representative of the U.S. economy, covering approximately 75% of the total sales in Compustat over the sample period between 1978 and 2013. Following [Barrot and Sauvagnat \(2016\)](#), I consider that a supplier and customer firms are linked all quarters from the first to the last quarter that the customer is reported by the supplier.

### 3.2 Empirical Facts

In this section, I present empirical evidence on the prevalence of lock-in innovations, a well-known fact about the relationship between market power and product differentiation, and two new findings on the connections between innovation, market power, product differentiation, and firm-to-firm innovation pass-through.

1. After 2000, 20% of firms’ innovations were lock-in innovations. Of these, 80% came from high-markup firms.
2. Higher markups are correlated with greater product differentiation, and this relationship has strengthened in the years following the 2000s.
3. After 2000, innovations by high-markup suppliers significantly increase product differentiation, while innovations by low-markup suppliers lead to non-significant changes in product differentiation. In contrast, before 2000, innovations by high-markup firms reduced product differentiation.
4. Post year 2000, innovations by high markup suppliers lead to a decline in customer firms’ sales, while innovations by low markup suppliers lead to an increase in customer firms’ sales. However, prior to 2000, innovations by high-markup firms led to an increase in customer firms’ sales.

When combined with the model's key predictions on innovation pass-through, these results inform the nature of innovation in the data. Through the lens of the model, the findings indicate that low-markup suppliers tend to invest in productive innovations that positively affect their customer firms' sales. In contrast, high-markup firms are more likely to pursue lock-in innovations that negatively impact customer firms' sales after 2000, but they were investing mostly in productive innovations during the pre-2000 period. I now present each empirical finding in detail.

### Fact 1: Prevalence of Lock-In Innovations

I use the model's predictions regarding the negative impact of supplier firms' lock-in innovations on their customers' sales to identify the prevalence of lock-in innovations in the data. I measure the number of lock-in patents by summing the patents granted to supplier firms that led to a decline in their customers' sales. I then calculate the share of lock-in innovations as the ratio of lock-in patents to the total number of patents granted to supplier firms in the sample. Since lock-in motives contribute to firms' market power, I further examine the role of high-markup firms by identifying lock-in patents placed by suppliers in the top 80th percentile of the markup distribution prior to the patent being granted. The results reveal that, after 2000, 20% of patents qualify as lock-in innovations, with 80% of these attributed to high-markup suppliers. Given the strong link between market power and lock-in innovations, I now turn to explore the relationship between high-markup suppliers and product differentiation.

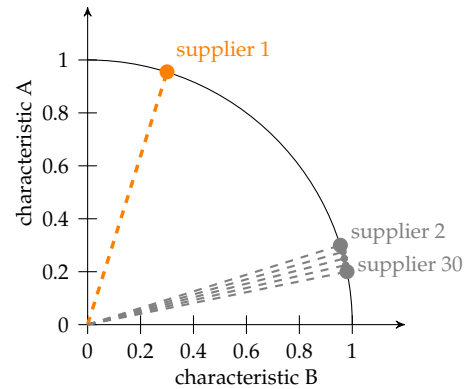
### Fact 2: Market Power and Product Differentiation

**Table 2:** Markups and Product Similarity

|                  | Pre-2000s             | Post-2000s            |
|------------------|-----------------------|-----------------------|
| Log Markups      | -0.139***<br>(0.0247) | -0.199***<br>(0.0126) |
| $R^2$            | 0.408                 | 0.571                 |
| Sector & Year FE | yes                   | yes                   |

Notes: Results from regressing the standardized firm-level HP product similarity score on the log of supplier firms' markups, controlling for sector and year fixed effects. Pre-2000 indicates the estimation for years previous to 2000, and Post-2000 the estimation for years after 2000.

**Figure 4:** Firms in the Product Space



Notes: Graphical representation of the firm's unit circle product space. The example illustrates a product space where firms are defined by two characteristics, A and B, and their position is determined by their products' content along these dimensions. In the figure, Supplier 1 is more differentiated than Suppliers 2 to 30, as it has a higher content of characteristic A and a lower content of characteristic B.

I document a negative correlation between supplier firms' markups and the HP product similarity score, as shown in Table 2. Before 2000, a 1% increase in a firm's markup is associated with a 0.14 standard deviation decrease in the cosine similarity index of its products relative to those of competitors (first column). After 2000, this correlation becomes stronger, with a 1% increase in markup corresponding to a 0.18 standard deviation decrease in the cosine similarity index (second column). These findings suggest that higher markups are linked to greater product differentiation, as firms position their products strategically within a space where distinctive features set them apart, while still retaining some similarities with competing offerings (Rosen, 1974; Lancaster, 1975). Greater product differentiation is associated with higher market power, as it reduces competitive pressures. Figure 4 illustrates the product space.

I provide additional evidence on the relationship between firms' markups and various measures of product differentiation in Appendix C. First, Table 11 (column 1) presents the results of a regression of the log of a firm's RD-to-sales ratio on a dummy variable indicating whether the firm belongs to the high-markup group. The findings show that high-markup firms, on average, invest 82% more in RD as a share of sales compared to other firms in the economy. I use the R&D expenditure share as a proxy for product specificity, following Barrot and Sauvagnat (2016). Second, I document that high-markup suppliers have higher probability of producing breakthrough innovations that are both novel and impactful. Kelly, Papanikolaou, Seru and Taddy (2021) construct a patent-level indicator of technological innovation based on textual analysis of patent documents. They identify important patents as those whose content is different from previous innovations (is novel) but similar to subsequent innovations (is impactful). Moreover, they define *breakthrough* innovations as those in the right tail of the distribution of importance. I combine their patent-level measure of innovation importance with the markup estimations of the firms that were granted the patents. Table 12 shows the correlation between high-markup firms and a dummy variable that indicates whether a patent represented a breakthrough innovation, in a window of 5 and 10 years respectively. The results reveal that high markup firms have a 63% higher probability of patenting a breakthrough innovation based on 5-year importance (column 1), and 61% higher probability of producing a breakthrough innovation based on 10-year importance (column 2).<sup>14</sup>

### **Fact 3: Innovation, Market Power and Product Differentiation**

While the relationship between product differentiation and market power is well documented, evidence on how product differentiation changes after firms innovate—and how this relates to firms' market power—remains elusive. I provide new empirical evidence on innovation, market power, and product differentiation. I estimate a local projection that analyzes how changes in a firm's HP similarity score after firm's innovation shocks depends on the firm's markups. This analysis combines HP similarity score data with measures of innovation shocks, defined as the excess stock market returns of patents assigned to the firm, alongside firm-level balance

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<sup>14</sup>Both specifications control for the patents' technological class and quarter fixed effects.



sheet data to estimate the following local projection:

$$\begin{aligned}\Delta \log HP_{s,t+h} = & \beta_{H,1} \sum_s Innov_{s,t} * \mathbf{1}_{\{s \in \text{high markup}\}} \\ & + \beta_{L,1} \sum_s Innov_{s,t} * [1 - \mathbf{1}_{\{s \in \text{high markup}\}}] \\ & + m_h \mathbf{1}_{\{s \in \text{high markup}\}} + \alpha_s + \alpha_{ith} + \Gamma'_h Z_{st-1} + e_{th}.\end{aligned}\quad (15)$$

The dependent variable,  $\Delta \log HP_{s,t+1}$ , represents the log change in the HP similarity score of supplier firm  $s$  from period  $t$  to  $t + 1$ . The variable  $\sum_s Innov_{s,t} * \mathbf{1}_{\{s \in \text{high markup}\}}$  captures the sum of innovation shocks  $Innov_{s,t}$  to firm  $s$  in year  $t$ , interacted with the indicator  $\mathbf{1}_{\{s \in \text{high markup}\}}$ , which takes the value of one if the supplier is in the top distribution of markups in period  $t - 1$ , prior to the innovation shock. The term  $\sum_s Innov_{s,t} * [1 - \mathbf{1}_{\{s \in \text{high markup}\}}]$  captures innovation shocks in year  $t$  for the remaining suppliers (i.e., the *low-markup* suppliers). The main coefficients of interest,  $\beta_{H,1}$  and  $\beta_{L,1}$ , measure the semi-elasticity of firm-level product differentiation to innovation shocks for high-markup and low-markup firms, respectively. I control for firm-specific factors  $Z_{s,t-1}$  that may influence product similarity, including firm size (total assets, total sales, and capital stock) and firm-level volatility. I also include the indicator  $\mathbf{1}_{\{s \in \text{high markup}\}}$  to control for permanent differences between high- and low-markup firms, firm fixed effects  $\alpha_s$  to capture time-invariant differences across firms, and industry-by-year fixed effects  $\alpha_{i,t}$  to account for sectoral heterogeneity, time trends, and their interaction. I cluster the standard errors by year.

I estimate regression 15 separately for the pre- and post-2000 periods, and present the results in Table 3. Before 2000, a one-dollar increase in innovation spending by a supplier firm led to non-significant changes in product similarity for low-markup firms. In contrast, high-markup firms experienced a significant 36% increase in product similarity during the first year, followed by a slightly negative but non-significant change in the second year after the innovation (panel (a)). The patterns shift notably in the post-2000 period. During this time, a one-dollar increase in innovation spending by a high-markup firm led to a statistically significant decrease in the product similarity score in the two years following the innovation, with reductions of 9% and 16%, respectively (panel (b)). In comparison, innovations by low-markup firms resulted in non-significant decreases in product similarity, with effect sizes two to five times smaller. These findings suggest that post-2000, high-markup firms are more likely to pursue lock-in innovations that increase product differentiation (or reduce product substitutability). In contrast, innovations by low-markup firms and high-markup firms before 2000 are less likely to take this form. This highlights the importance of a firm's position in the markup distribution when examining the nature of innovations. In the following section, I test the model's main predictions on the pass-through effects of innovations from suppliers to customers, conditioning on firms' position in the markup distribution.

**Table 3: Markups and Changes in Product Similarity after Innovation**

| (a) Pre-2000s          |                  |                 | (b) Post-2000s         |                  |                   |
|------------------------|------------------|-----------------|------------------------|------------------|-------------------|
|                        | Year=1           | Year=2          |                        | Year=1           | Year=2            |
| Low Markups            | 0.07<br>(0.17)   | -0.12<br>(0.14) | Low Markups            | 0.05<br>(0.08)   | -0.03<br>(0.09)   |
| High Markups           | 0.36**<br>(0.15) | -0.02<br>(0.24) | High Markups           | -0.09*<br>(0.05) | -0.17**<br>(0.07) |
| $R^2$                  | 0.615            | 0.682           | $R^2$                  | 0.453            | 0.619             |
| Firm, Sector & Year FE | yes              | yes             | Firm, Sector & Year FE | yes              | yes               |

Notes: estimation results of the semi-elasticity of changes in HP Similarity Score to firm-level innovation shocks, conditioning on the firm belonging to the top 80th percentile distribution of markups (High Markups), or not (Low Markups). See equation 15 for specification details.

#### Fact 4: Market Power and Innovation pass-through from Supplier to Customer Firms

I combine data on supplier-customer linkages with firm-level financials, innovation shocks, and supplier markup estimates to estimate how innovation pass-through from supplier to customer firms. Table 4 presents summary statistics of the sample used in the analysis. I winsorize the sample at the top and bottom 0.5% of observations to ensure the results are not driven by outliers. Panel (a) presents statistics for the supplier firm's sample, divided into those with high-markups and those with low-markups. I define *high-markup supplier firms* as those whose markups are in the 80th percentile of markup distribution or higher, and categorized the rest of supplier firms as *low-markup supplier firms*. There are 490 high-markup and 831 low-markup suppliers in the sample, with 5729 and 14107 firm-quarters observations respectively, from 1984 to 2010. High-markup suppliers on average receive larger innovation shocks (1.98 vs 0.65)<sup>15</sup>, have 1.8 times higher markups on average, have slightly smaller size in terms of sales, but have higher profits and assets than low-markup supplier firms. High-markup firms have 1.38 customers and low-markup firms have 1.48 customers on average.<sup>16</sup> Panel (b) presents the summary statistics for the customer firms in the sample. There are 367 customer firms in the sample, with 9132 firm-quarter observations from 1984 to 2010. Customer firms have an average markup of 1.33 and exhibit greater size (both in terms of sales and assets) and profits compared to supplier firms. On average, they are connected to 3.15 suppliers.

<sup>15</sup>Consistent with Kogan *et al.* (2017), the distribution of innovations across firms is highly-skewed.

<sup>16</sup>Notice that given the structure of SFAS No.131, a firm in the sample can have at most 10 customers.

**Table 4: Summary Statistics****(a) Supplier firms**

|                   | High-Markups Suppliers |      |      |      |      | Low-Markups Suppliers |      |      |      |      |
|-------------------|------------------------|------|------|------|------|-----------------------|------|------|------|------|
|                   | mean                   | sd   | p25  | p50  | p90  | mean                  | sd   | p25  | p50  | p90  |
| innovation shocks | 1.98                   | 4.53 | 0.00 | 0.00 | 6.17 | 0.65                  | 1.99 | 0.00 | 0.00 | 1.84 |
| markups           | 1.85                   | 0.63 | 1.43 | 1.63 | 3.24 | 1.03                  | 0.29 | 0.91 | 1.07 | 1.31 |
| log sales         | 4.05                   | 2.01 | 2.65 | 3.88 | 7.00 | 4.17                  | 1.98 | 2.76 | 4.07 | 6.99 |
| log profits       | 3.41                   | 2.03 | 1.95 | 3.24 | 6.43 | 2.96                  | 1.87 | 1.71 | 2.79 | 5.53 |
| log assets        | 5.52                   | 2.11 | 3.99 | 5.34 | 8.44 | 5.49                  | 1.91 | 4.17 | 5.27 | 8.19 |
| nr of customers   | 1.38                   | 0.70 | 1.00 | 1.00 | 2.00 | 1.48                  | 0.78 | 1.00 | 1.00 | 3.00 |
| Observations      | 5729                   |      |      |      |      | 14107                 |      |      |      |      |

**(b) Customer firms**

|                 | All Customers |      |      |      |       |
|-----------------|---------------|------|------|------|-------|
|                 | mean          | sd   | p25  | p50  | p90   |
| markups         | 1.34          | 0.72 | 0.99 | 1.16 | 1.90  |
| log sales       | 7.64          | 1.44 | 6.81 | 7.85 | 9.41  |
| log profits     | 6.44          | 1.41 | 5.57 | 6.59 | 8.25  |
| log assets      | 8.86          | 1.51 | 7.98 | 9.01 | 10.80 |
| nr of suppliers | 3.15          | 4.96 | 1.00 | 1.00 | 7.00  |
| Observations    | 9132          |      |      |      |       |

Notes: Panel (a) shows summary statistics for Supplier firms in the sample, conditioning on the firm belonging to the top 80th percentile distribution of markups (High Markups), or not (Low Markups). Panel (b) shows summary statistics for Customer firms in the sample.

I analyze how customer firms respond to innovations by high market power suppliers using local projection methods following [Jordà \(2005\)](#). To test the model's predictions on innovation pass-through, I focus on customer firms' sales as the primary outcome, while considering additional outcomes to explore alternative mechanisms and robustness checks. The empirical specification is given by:

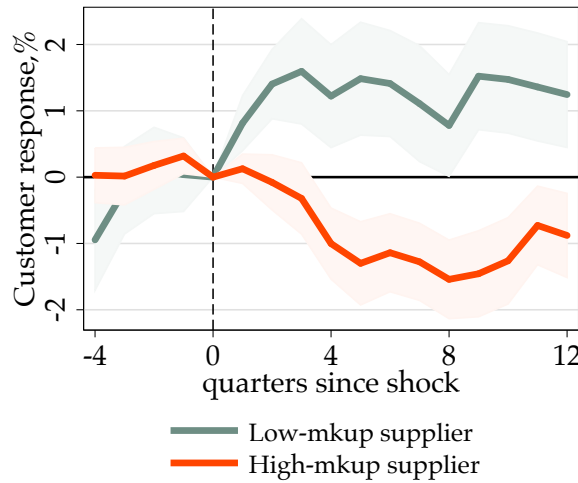
$$\begin{aligned}
\Delta \log Sales_{ct+h} = & \beta_{H,h} \sum_s \omega_{sct} Innov_{st} * \mathbf{1}_{\{s \in \text{top markup}\}} \\
& + \beta_{L,h} \sum_s \omega_{sct} Innov_{st} * [1 - \mathbf{1}_{\{s \in \text{top markup}\}}] \\
& + m_h \mathbf{1}_{\{s \in \text{high markup}\}} + \alpha_c + \alpha_{ith} + \Gamma'_h Z_{ct-1} + e_{th}
\end{aligned} \tag{16}$$

In line with the local projection specification [15](#), the variable  $Innov_{s,t} * \mathbf{1}_{\{s \in \text{high markup}\}}$  represents innovation shocks from supplier firms interacted with an indicator that equals one if the supplier is in the top markup distribution. However, since the outcome of interest is now customer firm sales, I weight the sum of innovation shocks from all high-markup suppliers  $s$  within a quarter by supplier  $s$ 's share of total sales to customer firm  $c$  in period  $t$ , denoted by  $\omega_{sct}$ , resulting in the term  $\sum_s \omega_{sct} Innov_{st} * \mathbf{1}_{\{s \in \text{top markup}\}}$ . I apply the same approach for innovation shocks from low-markup suppliers, yielding the term  $\sum_s \omega_{sct} Innov_{st} * [1 - \mathbf{1}_{\{s \in \text{top markup}\}}]$ . The coefficients of interest,  $\beta_{H,h}$  and  $\beta_{L,h}$  measure the cumulative response of customer firm

sales in quarter  $t + h$  to a 1 standard-deviation increase in innovation by high-markup and low-markup supplier firms, respectively.<sup>17</sup> I control for customer firm characteristics  $Z_{c,t-1}$  that may influence sales, including size (total assets and capital stock), volatility, and the value of the firm's own innovation shocks (measured as the excess stock market return of innovations attributed to the customer firm). I also include the indicator  $\mathbf{1}_{\{s \in \text{high markup}\}}$  to control for permanent differences between high- and low-markup suppliers, customer firm fixed effects  $\alpha_c$  to capture time-invariant differences, and customer industry-by-quarter fixed effects  $\alpha_{i,th}$  to account for sectoral heterogeneity, time trends, and their interactions. Standard errors are clustered by quarter.

I first estimate specification 16 for the years after 2000. Figure 5 shows the cumulative differential response of customer firms to innovation shocks by supplier firms with high markups (coefficient  $\beta_{H,h}$  in equation 16) and to innovation shocks by supplier firms with low markups (coefficient  $\beta_{L,h}$  in equation 16) from the quarter since the innovation shock and until three years later. A one standard deviation increase in innovation by low-markup suppliers leads to an increase of up to 1.3% in the sales growth of customer firms. A similar increase in innovation by high-markup suppliers results in a decline of up to 1.4% in customer firm sales growth two years after the innovation, with the effect gradually reversing four years post-shock.

**Figure 5:  $\Delta$  Customer Sales after Supplier Innovation**



Notes: estimation results of the semi-elasticity of changes Customer sales after Supplier's innovation shocks, conditioning on the firm belonging to the top 80th percentile distribution of markups (High Markups), or not (Low Markups). See equation 16 for specification details.

In summary, the results show that, in the post-2000s period, innovations by low-markup suppliers lead to an increase in customer firms' sales growth, whereas innovations by high-markup suppliers result in a decline in customer sales growth. This pattern is consistent with the model's predictions on the pass-through effects of productive versus lock-in innovations. High-markup firms are more likely to pursue lock-in innovations that allow them

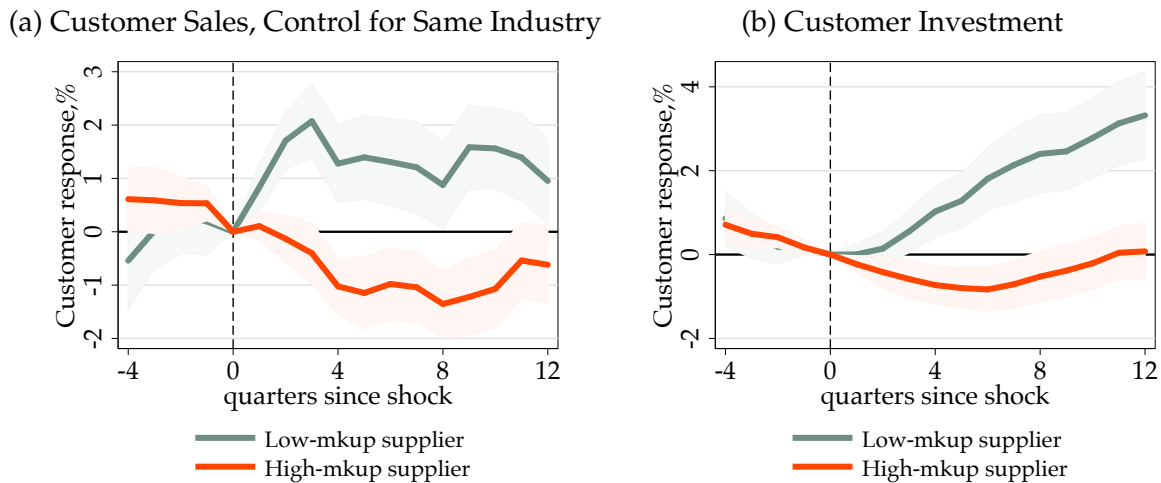
<sup>17</sup>The measure of innovation shocks is standardized to facilitate comparisons with alternative measures considered in robustness checks and to align with estimates in Kogan *et al.* (2017), which examine the response of firms' outcomes to their own innovation shocks.

to raise prices, which their customer firms cannot pass on to final good producers. As a result, customers bear the higher input costs, ultimately harming their own sales growth. In contrast, low-markup firms tend to invest in productive innovations that lower the customer firm’s marginal costs, boosting their sales growth.

I explore and rule out other potential explanations for the empirical patterns observed in Figure 5 that are not related to changes in product differentiation driven by innovation. First, I consider the possibility that high-markup supplier firms may be “stealing business” from their customer firms, thereby contributing to the decline in customer sales observed in the data. To test this, I re-estimate specification 16 while controlling for the differential response of customer firms that operate in the same industry as their suppliers, using both 4-digit and 2-digit SIC industry classifications. The results remain robust, as shown in Figure 6, panel (a), suggesting that the decline in customer sales is not due to high-markup suppliers taking business away from their customers.

Second, I examine whether the relative decline in customer firms’ real output and profits could be explained by short-term technology adoption costs that arise after their suppliers innovate. To investigate this, I re-estimate specification 16 using customer firms’ investment as the outcome variable. As shown in Figure 6, panel (b), customer firms experience a short-run decline in investment following innovation shocks from high-markup suppliers, which is inconsistent with the hypothesis that customers are incurring additional costs to adapt their production processes to new technologies introduced by their suppliers.

**Figure 6: Business Stealing? Technology Adoption Costs?**

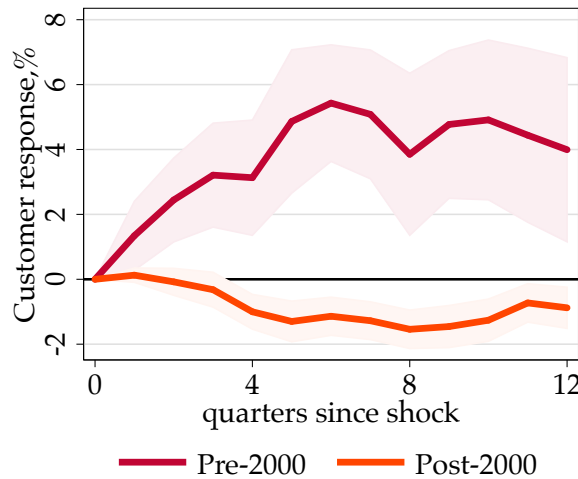


Notes: Panel (a) shows estimation results of the semi-elasticity of changes Customer sales after Supplier’s innovation shocks, controlling for the supplier being in the sample industry as the customer firm, and conditioning on the firm belonging to the top 80th percentile distribution of markups (High Markups), or not (Low Markups). Panel (b) shows estimation results of the semi-elasticity of changes Customer investment after Supplier’s innovation shocks, conditioning on the firm belonging to the top 80th percentile distribution of markups (High Markups), or not (Low Markups).

Given the evidence from Fact 1 and Fact 2 on the increasing prevalence of lock-in innovations in the post-2000 period—both in terms of the correlation between markups and product differentiation, and the changes in product differentiation following innovations by high-markup

firms—a natural next step is to compare the pass-through of innovations from high-markup supplier firms to their customer firms across the two periods. Figure 7 presents the estimated coefficient  $\beta_{H,h}$  from the specification 16, estimated separately for the pre- and post-2000 periods. Notably, before 2000, innovations by high-markup firms led to an increase in customer firms' sales of up to 5.8%, suggesting that these firms primarily invested in productive innovations during this period. In contrast, post-2000 innovations by high-markup firms resulted in a negative response in customer sales, indicating a shift toward a higher prevalence of lock-in innovations.

**Figure 7:**  $\Delta$  Customer Sales after High-Markup Supplier Innovation



Notes: estimation results of the semi-elasticity of changes Customer sales after Supplier's innovation shocks for years previous and after 2000, conditioning on the firm belonging to the top 80th percentile distribution of markups (High Markups).

Overall, the empirical results indicate a rise in the prevalence of lock-in innovations in the years following 2000. I use these findings to calibrate key parameters of the model and quantify the aggregate impact of both lock-in and productive innovations on aggregate total factor productivity (TFP) and market power.

## 4 Quantitative Analysis

This section quantifies the implications of lock-in and productive innovations for aggregate TFP and the dispersion of markups. To do this, I first calibrate the model from Section 2 to match the empirical patterns from Section 3.2 along with other variables of interest for the post-2000 period. Using this baseline calibration, I describe firms' investment strategies in lock-in and productive innovations to provide intuition about the model. I then re-calibrate the model to match the empirical patterns from Section 3.2 for the pre-2000 period. Next, I conduct a counterfactual analysis to quantify what aggregate TFP and markup dispersion in the post-2000 period would have been if the cost structure of lock-in innovations had remained the same as in the pre-2000 period.



#### 4.1 Baseline Calibration: Post-2000s

The model has 13 structural parameters, described in Table 5, which identification happens in three ways. First, two parameters are externally calibrated to match existing results in the literature  $(\rho, \psi)$ , (Table 5, Panel A). I set the households' discount rate parameter to  $\rho = 6\%$ . For the curvature of the cost function of productive innovations, I consider a quadratic function with  $\psi = 2$ , in line with previous results in the literature that estimate the elasticity of patenting to R&D expenditures (Acemoglu and Akcigit, 2012; Acemoglu, Akcigit, Hanley and Kerr, 2016). Second, two other parameters are directly matched to microdata (Table 5, Panel B): I set the lock-in innovation step-size,  $\delta$ , to match the empirical fact presented in Section 3.2 on the change in product similarity after high-markup firms—which are the ones most likely to invest in lock-in—innovate. I take the probability of market reset,  $\kappa$ , to be given by the average firm entry rate, since in the model it reflects situations in which new firms enter to compete with incumbents, leveling the substitutability between firms. I use estimates for the entry rate in US by Akcigit and Ates (2021), which are based on U.S. Census Bureau's Business Dynamics Statistics. For the remaining nine parameters  $(\eta, \lambda, \tilde{\psi}, \phi_s, \phi_{-s}, \tilde{\phi}_s, \tilde{\phi}_{-s}, \alpha, \tilde{\alpha})$ , I perform an internal calibration in two steps (Table 5, Panel C): I replicate the empirical facts on innovation pass-through between suppliers and customer firms from Section 3.2 using data generated by the model, and I target data moments that are informative about relevant features of the model. Next, I describe these two identification steps in detail.

##### Replicating the empirical facts from Section 3

A crucial identification step involves replicating the regressions of Section 3 using data simulated from the model. I simulate a panel of 1000 sectors for 200 years, taking into account all the possible events that can happen in the economy, which probabilities are determined by the firms' lock-in and productive policy functions and the probability of market reset,  $\kappa$ .<sup>18</sup> Using the model-generated data, I run the local projection from equation (16), regressing the change in the customer sales after innovations (both lock-in and productive) performed by the supplier firm. To define the low- and high-markup suppliers, I use the same criteria that I used in the empirical section, and consider the high-markup firms as those who belonged to the 80-th percentile or higher of the markup distribution ex ante the innovation happened, and low-markup firms as the remaining ones. Figure 8 shows the dynamic response of customer sales to innovations by low- and high- markup suppliers, both in the data and in the model.

When combined with the predictions of the model on the positive response of customer sales after productive innovations by suppliers, and the negative response of customer sales to lock-in innovations by suppliers, the dynamic response of customer firms' sales to innovations by low- and high-markup suppliers observed in the data are informative of the parameters governing the relationship between the cost of productive and lock-in innovations and the markup

<sup>18</sup>I consider a sector as a group of two (supplier) firms that provide their inputs to the customer (sector) firms. Since suppliers are ex-ante homogeneous, this is equivalent to simulating one sector for 100,000 years.

of the firm, i.e.,  $\phi_s, \phi_{-s}, \tilde{\phi}_s, \tilde{\phi}_{-s}$ .<sup>19</sup> The dynamics of innovation pas-through are also informative of the overall prevalence of each type of innovation, therefore are informative the convexity of lock-in innovations,  $\tilde{\psi}$  (given that the convexity of productive innovations is externally calibrated).

**Table 5:** Parameter Values: Post-2000 Period

| Parameter                         | Description   | Value |
|-----------------------------------|---|-------|
| — Panel A. External Calibration — |   |       |
| $\rho$                            | Rate of time preference                                   | 6%    |
| $\psi$                            | Productive innovation cost curvature                      | 2     |
| — Panel B. Direct Match to Data — |   |       |
| $\delta$                          | Lock-in innovation step size                              | 17%   |
| $\kappa$                          | Market reset probability                                  | 10%   |
| — Panel C. Internal Calibration — |   |       |
| $\eta$                            | Elasticity of substitution between customers              | 1.5   |
| $\lambda$                         | Productive innovation step size                           | 3.3%  |
| $\tilde{\psi}$                    | Lock-in innovation cost curvature                         | 2.8   |
| $\phi_s$                          | Productive innovation cost relation w/ productivity level | 2.8   |
| $\phi_{-s}$                       | Productive innovation cost relation w/ productivity level | 0     |
| $\tilde{\phi}_s$                  | Lock-in innovation cost relation w/ productivity gap      | -2.8  |
| $\tilde{\phi}_{-s}$               | Lock-in innovation cost relation w/ productivity gap      | -2.8  |
| $\alpha$                          | Productive innovation scale                               | 1     |
| $\tilde{\alpha}$                  | Lock-in innovation scale                                  | 0.5   |

Notes: List of model parameters and calibrated values for the Post-2000 economy.

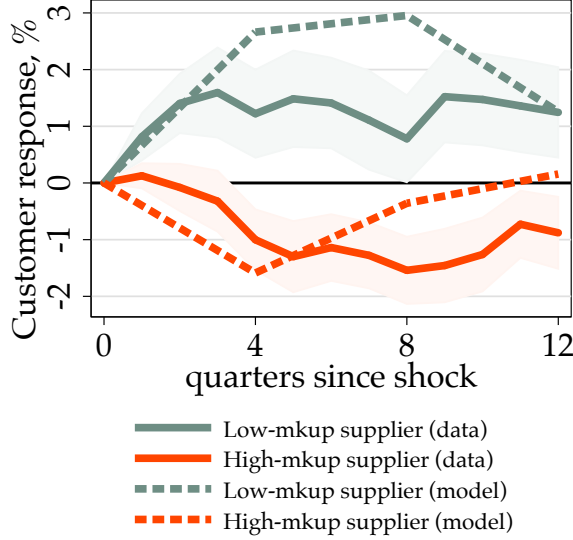
### Targeted moments

The second step of the internal calibration involves targeting some moments of interest: the average markup and moments of the markup distribution, the average annual ratio of R&D spending to GDP, sourced from the National Science Foundation data, and the profit share of GDP, which I take from estimates in [Akcigit and Ates \(2021\)](#). Table 6 presents the list of targeted moments for the Post-2000 calibration and its comparison with the data. One target is the average markup rate and the distribution of markups (75th and 90th percentile). As described in Section 2.2.1, in the model markups are endogenous to the suppliers' productivity and substitutability, therefore the average markup level and the markup dispersion are informative of the step-size of productive innovations,  $\lambda$ , as well as the innovation scale parameters,

<sup>19</sup>Since in the model markups are endogenous and increasing on the firms' productivity gap relative to its competitor, these four parameters discipline the relationship between the cost of innovation and the markup of the firm.

$\alpha$  and  $\tilde{\alpha}$ . Another targeted moment is the the Since in the model innovations are driven by both productive and lock-in incentives, the R&D share of GDP disciplines the scale parameters of productive and lock-in innovations as well.

**Figure 8:**  $\Delta$  Customer Sales to Supplier Innovation



**Table 6:** Model Fit

| Moment                 | Model | Data |
|------------------------|-------|------|
| Average markup         | 1.46  | 1.34 |
| Markup 75th percentile | 1.57  | 1.54 |
| Markup 90th percentile | 1.71  | 1.92 |
| R&D share of GDP, %    | 1.59  | 1.65 |
| Profit share of GDP, % | 14    | 17   |

Notes: Figure 8 shows data and model estimation results of the semi-elasticity of changes in Customer sales after Supplier's innovation shocks for post-2000 period, conditioning on the firm belonging to the top 80th percentile distribution of markups (High Markups), or not (Low Markups). Table 6 presents the value of moments in the data and in the calibrated model for the post-2000 period.

## 4.2 Properties of the Baseline Estimation

The first order conditions of problem 11 with respect to the two types of innovation yield the optimal productive and lock-in innovation decisions:

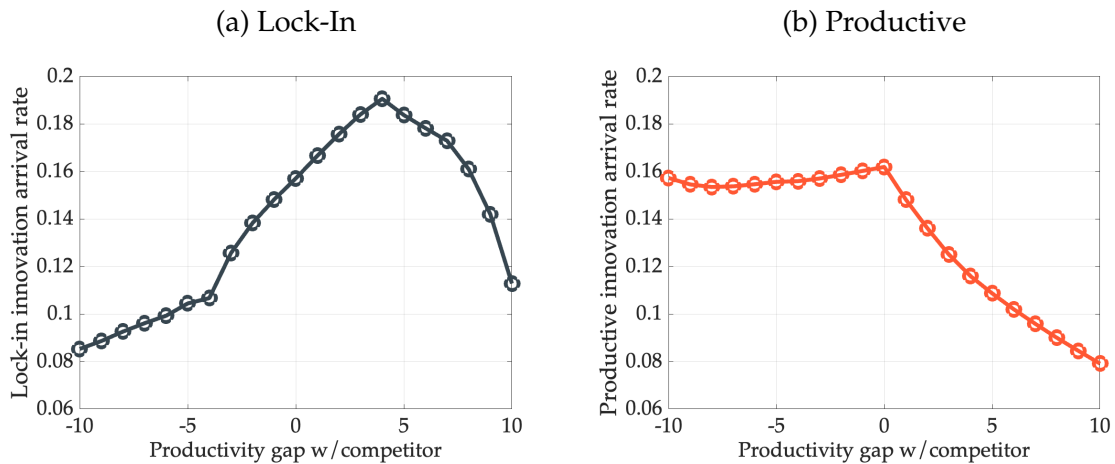
$$i_{st} = \frac{1}{\exp(a_{st}^{\psi_s} - a_{-st}^{\psi_{-s}})} \left[ \frac{1}{\alpha W_t} (V_t(a_s + \lambda, a_{-s}, \gamma_s, \gamma_{-s}) - V_t(a_s - \lambda, a_{-s}, \gamma_s, \gamma_{-s})) \right]^{\frac{1}{\phi-1}}$$

$$z_{st} = \frac{1}{\exp(a_{st}^{\tilde{\psi}_s} - a_{-st}^{\tilde{\psi}_{-s}})} \left[ \frac{1}{\tilde{\alpha} W_t} (V_t(a_s, a_{-s}, \gamma_s - \delta, \gamma_{-s}) - V_t(a_s, a_{-s}, \gamma_s, \gamma_{-s})) \right]^{\frac{1}{\phi-1}}.$$

Figure 9 presents the policy functions for lock-in and productive innovations across different values of the log-productivity gap between a firm and its competitor, based on the baseline estimation described in Section 4.1. Panel (a) displays the arrival rate of lock-in innovations. The investment intensity in lock-in innovations follows a hump-shaped pattern relative to the productivity gap. For firms lagging behind their competitors in productivity, the intensity of lock-in innovation increases with the productivity gap, peaking at a moderate positive gap. Beyond this point, the intensity declines sharply for firms that are significantly more productive than their competitors. This pattern aligns with the relationship between productivity gaps, profits, and product substitutability discussed in Section 2.2.1. Specifically, profits increase as products become less substitutable, up to a point where the firm gains a substantial productivity advantage. Beyond this threshold, firms benefit more from offering more substitutable

products, enabling them to capture a larger share of the market and further increase profits. This highlights one of the main contributions of the paper: characterizing the incentives for firms to pursue lock-in innovations—an area previously unexplored. By linking the model’s predictions with the empirical evidence on innovation pass-through, I provide a disciplined framework to better understand these incentives. Panel (b) displays the arrival rate of productive innovations, which also follows a hump-shaped pattern but peaks when the firm and its competitor have equal productivity levels. This result is well-established in the literature that studies the relationship between competition and innovation (Aghion *et al.*, 2001; Aghion, Bloom, Blundell, Griffith and Howitt, 2005).

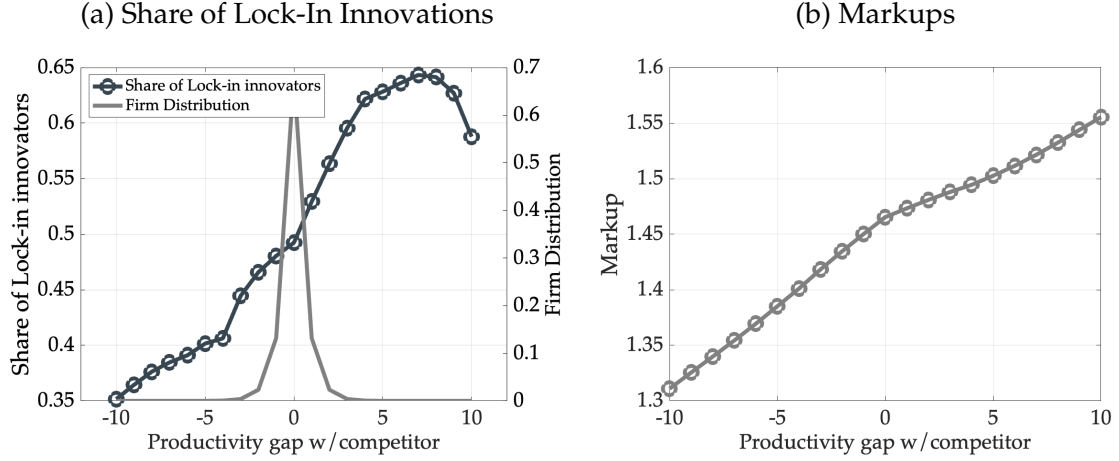
**Figure 9: Innovation Policy Functions**



Notes: calibrated model lock-in (panel (a)) and productive (panel (b)) innovations’ policy functions, against the supplier’s productivity gap (in terms of number of steps) with respect to their competitor.

How does the composition of lock-in and productive investments within the innovation portfolio change with the productivity gap? Figure 10 illustrates the share of lock-in innovations in the total innovation portfolio, measured as  $\frac{z_s}{z_s + i_s}$ . The share of lock-in innovations rises sharply with the productivity gap, starting at 35% when the firm is lagging by ten steps behind its competitor and reaching 65% when the firm is ahead by seven steps. Beyond this point, the share of lock-in innovations declines. The figure also includes the distribution of firms across productivity gaps as implied by the baseline model. Panel (b) shows the increasing relationship between the productivity gap of the firm and the markups in the model. Together, the figures suggest that, in equilibrium, there are no firms in regions where high-markup firms do not pursue lock-in innovations. Consequently, in areas with a positive density of firms, the model exhibits a positive relationship between markups and the share of investment in lock-in innovations.

**Figure 10:** Share of Lock In Innovations, Markups, and Productivity Gap



Notes: Panel (a) shows the share of lock-in innovations in the total innovation portfolio,  $\frac{z_s}{z_s + I_s}$  together with the calibrated model firm's distribution, against the supplier's productivity gap (in terms of number of steps) with respect to their competitor. Panel (b) shows the calibrated model relationship between a supplier's markups and its productivity gap (in terms of number of steps) with respect to their competitor.

### 4.3 Innovation Pass-Through Without Lock-In

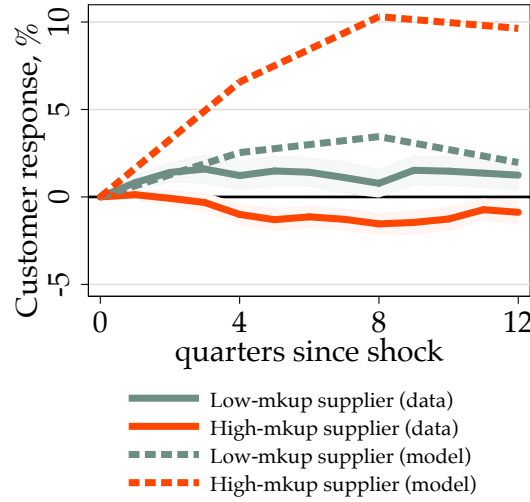
In this section, I explore a counterfactual scenario in which the cost-scale parameter of lock-in innovations,  $\tilde{\alpha}$ , is set to infinity. This exercise provides intuition for why the inclusion of lock-in innovations in the model is essential to replicate the decline in customer sales after innovations by high-markup suppliers observed in the data. I simulate a panel of firms under this counterfactual scenario, where the cost of lock-in innovations becomes prohibitively high, and estimate the response of customer sales to innovations by supplier firms.

Figure 11 presents the results, comparing the local projections from Section 3.2—capturing the response of customer sales to innovations by high- and low-markup suppliers—with model-based local projections in the absence of lock-in innovations. Without lock-in innovations, the response of customer sales would always be positive. Moreover, innovations by high-markup suppliers would generate a stronger response in customer sales than those by low-markup suppliers, implying that high-markup firms pass-through more of the productivity improvements to their customers.<sup>20</sup> This counterfactual highlights that lock-in innovations are necessary for the model to align with the empirical evidence presented in Section 3.2.

Appendix Figure 15 compares the policy functions for both lock-in and productive innovations under the counterfactual scenario, where the lock-in innovation scale parameter is set to infinity, with those in the baseline (Post-2000) economy. The comparison reveals that lock-in investments crowd out productive investments.

<sup>20</sup>This result aligns with the findings of [Amiti, Itskhoki and Konings \(2019\)](#), which show that high-markup firms pass through a smaller share of negative cost shocks to their customers.

**Figure 11:  $\Delta$  Customer Sales under No Lock-in Scenario**



Notes: data estimation results of the semi-elasticity of changes in Customer sales after Supplier's innovation shocks, conditioning on the firm belonging to the top 80th percentile distribution of markups (High Markups), or not (Low Markups), compared with the model estimation results for the counterfactual scenario in which lock-in innovations are infinitely costly.

#### 4.4 Pre-2000s Calibration

I re-estimate the model for the Pre-2000 economy, applying the same identification strategy used for the Post-2000 estimation described in Section 4.1. The estimated parameters for both steady states are presented in Table 7, and the list of targeted moments for both periods is presented in Table 8. Beside the moments described before, I also target the aggregate TFP level ratio between Post-2000 and Pre-2000 period, sourced from the Bureau of Economic Analysis.<sup>21</sup>

I account for changes in parameters between the Pre- and Post-2000 periods that align with other explanations for the slowdown in business dynamism and the rise in market power observed after 2000. Compared to the Pre-2000 period, the cost-elasticity of productive innovations with respect to the firms' productivity,  $\phi_s$ , is higher in the Post-2000 period, reflecting the hypothesis from Bloom, Jones, Van Reenen and Webb (2020) that coming up with new ideas has become increasingly difficult. The step-size of productive innovations,  $\lambda$ , declines in the Post-2000 period, indicating an average decrease in patent quality, as studied by Olmstead-Rumsey (2019). Furthermore, the firm's entry rate, captured by the market reset probability  $\kappa$ , declines in the Post-2000 period, in line with the findings of Akcigit and Ates (2021).

As it has been widely documented, in the Post-2000 period there has been a significant increase in the markup level and also in the markup dispersion, which disciplines the differences in productive innovation step-size and the innovation scale parameters. Crucially, the parameters governing the elasticity of lock-in and productive innovations' costs with respect to the productivity gap,  $\phi_s, \phi_{-s}, \tilde{\phi}_s, \tilde{\phi}_{-s}$  are informed by changes in the empirical response of customer sales to supplier innovations. Specifically, in the Pre-2000 period, customer sales exhibit a positive response to innovations by high-markup suppliers, contrasting with the negative response

<sup>21</sup>I target the aggregate TFP ratio to reflect observed changes in aggregate trends, which I achieve by raising the lower bound of productivity levels in the post-2000 period to capture shifts in the technological frontier over time.



observed in the Post-2000 period. Figure 12 shows the dynamic response of customer sales to innovations by high-markup suppliers in the Pre- and Post-2000 periods, both in the data and in the local projections simulated in the model.

**Table 7: Parameter Values: Pre-2000 vs Post-2000 Periods**

| Parameter        | Description   | Pre-2000 Value | Post-2000 Value |
|------------------|---|----------------|-----------------|
| $\rho$           | Rate of time preference                               | 6%             | 6%              |
| $\eta$           | Elasticity of substitution between customers          | 1.5            | 1.5             |
| $\lambda$        | Productive innovation step size                       | 3.5%           | 3.3%            |
| $\delta$         | Lock-in innovation step size                          | 17%            | 17%             |
| $\psi$           | Productive innovation cost curvature                  | 2              | 2               |
| $\tilde{\psi}$   | Lock-in innovation cost curvature                     | 3              | 2.8             |
| $\phi$           | Productive innov. cost relation w/ productivity level | 2.5            | 2.8             |
| $\tilde{\phi}$   | Lock-in innov. cost relation w/ productivity level    | -2             | -2.8            |
| $\alpha$         | Productive innovation scale                           | 0.5            | 1               |
| $\tilde{\alpha}$ | Lock-in innovation scale                              | 2              | 0.5             |
| $\kappa$         | Market reset probability                              | 12%            | 10%             |

Notes: List of model parameters and calibrated values for the Post-2000 economy.

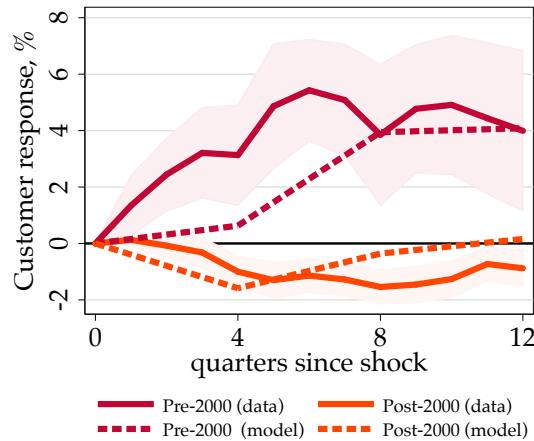
**Table 8: Model Fit**

| Moment                 | Model Pre-2000 | Data Pre-2000 | Model Post-2000 | Data Post-2000 |
|------------------------|----------------|---------------|-----------------|----------------|
| Average markup         | 1.3            | 1.2           | 1.46            | 1.34           |
| Markup 75th percentile | 1.4            | 1.3           | 1.57            | 1.54           |
| Markup 90th percentile | 1.5            | 1.6           | 1.71            | 2.20           |
| R&D share of GDP, %    | 3.7            | 1.5           | 1.59            | 1.65           |
| Profit share of GDP, % | 10             | 16            | 17              | 14             |
| Aggregate TFP ratio    | 1              | 1             | 1.10            | 1.10           |

Notes: Table 6 presents the value of moments in the data and in the calibrated model for the Pre-2000 and the Post-2000 periods.

"Aggregate TFP ratio" refers to the ratio of aggregate TFP between Post-2000 and Pre-2000 periods.

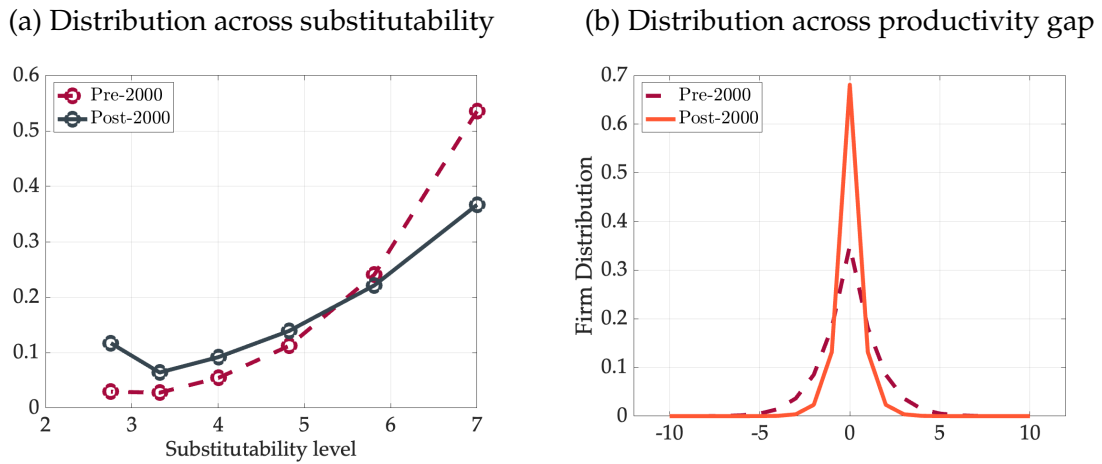
**Figure 12:  $\Delta$  Customer Sales after Innovation by High-Markup Suppliers**



## 4.5 Comparison Between the Pre-2000 and the Post-2000 Economies

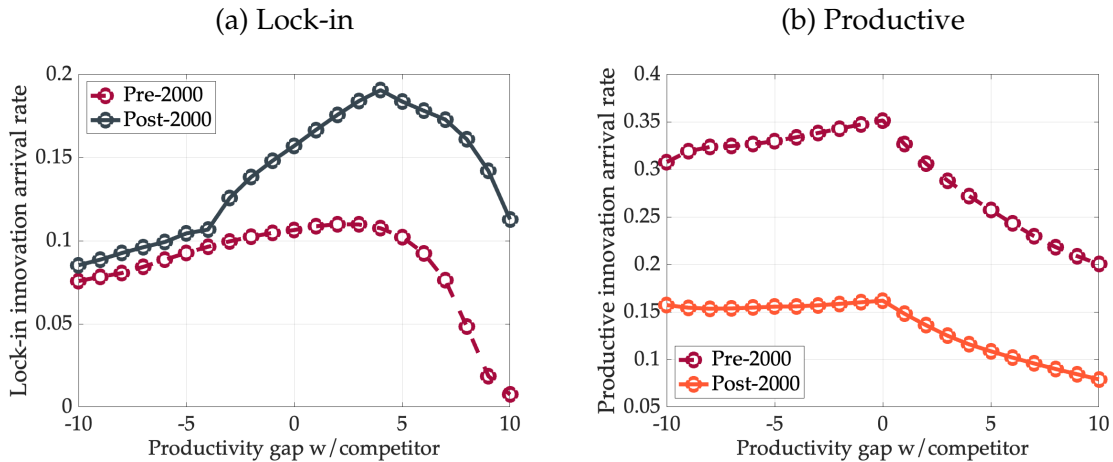
From the pre-2000 to the post-2000 period, the economy experienced a noticeable shift toward lower product substitutability, with firms producing less standardized products (Figure 13, panel (a)). At the same time, the distribution of productivity gaps became more compressed, reflecting a reduction in the dispersion of productivity across firms (Figure 13, panel (b)). When combined with the observed increase in both average markup levels and markup dispersion, these trends suggest that, in the post-2000 economy, firms increasingly derive market power from lower product substitutability rather than from large productivity advantages over their competitors. Figure 14 illustrates the changes in both the level and composition of innovation intensity by comparing the lock-in and productive innovation policy functions across the two periods. Panel (a) reveals that the intensity of lock-in investments nearly doubled in the post-2000 period among firms with higher markups, i.e., larger productivity gap. Panel (b) shows a decline in overall productive innovation intensity during the post-2000 period.

**Figure 13: Firm Distribution: Pre-2000 vs Post-2000**



Notes: Pre-2000 and Post-2000 distributions. Panel (a) shows the calibrated firm distribution across product substitutability  $\gamma$ 's. Panel (b) shows the firm distribution across firm's productivity gaps (in terms of number of steps) with respect to their competitor.

**Figure 14: Innovation Policy Functions: Pre-2000 vs Post-2000**



Notes: Panel (a) shows the lock-in policy functions Pre- and Post-2000, and Panel (b) shows the productive innovations' intensity.

## 4.6 What are the Aggregate Implications of Lock-In innovations?

I construct a counterfactual scenario to assess what aggregate TFP, markup levels, and markup dispersion would have been if the post-2000 economy had retained the lock-in innovation cost structure of the pre-2000 period. Specifically, I re-estimate the post-2000 economy by resetting the cost scale parameter  $\tilde{\alpha}$ , the cost curvature parameter  $\tilde{\phi}$ , and the elasticity of lock-in costs with respect to the productivity gap  $\tilde{\psi}_s$  and  $\tilde{\psi}_{-s}$  to their pre-2000 values. The results are presented in Table 9. The first two columns display the ratio of Post-2000 to Pre-2000 aggregate TFP, median markups, and markup dispersion, both in the data (first column) and from the two steady-state model estimations presented in the previous section (second column). In both the data and the model, aggregate TFP in the Post-2000 period is 10% higher than in the Pre-2000 period. The median markup is 7% higher in the Post-2000 period compared to the Pre-2000 period in the data and 4% higher in the model. Markup dispersion, measured as the ratio of the 75th to the 25th percentile of markups, is 15% higher Post-2000 in the data and 12% higher in the model. Overall, the model closely matches the observed data, capturing the changes in aggregate productivity and markup moments across the two periods.

The third column of Table 9 presents the results of the counterfactual scenario, where I reset the cost structure of lock-in innovations in the post-2000 economy to pre-2000 values, holding all other parameters constant. If lock-in innovations had remained as costly as they were in the pre-2000 period, the observed increase in aggregate TFP in the post-2000 period would have been 1.13 instead of 1.10—30% higher than its actual value. Second, the median markup, which is 4% higher in the post-2000 estimation, would have remained at the pre-2000 level. Finally, markup dispersion would have increased by only 2% in the post-2000 period compared to the pre-2000 period—compared to the 12% increase observed in the model—implying an 83% reduction in the increase of markup dispersion.

**Table 9:** Counterfactual: Post-2000 Economy with Pre-2000 Lock-in

| Ratio: Post-2000 / Pre-2000 | Data | Model | Counterfactual |
|-----------------------------|------|-------|----------------|
| Aggregate TFP               | 1.10 | 1.10  | 1.13           |
| Median markup               | 1.07 | 1.04  | 1.00           |
| Markup dispersion           | 1.15 | 1.12  | 1.02           |

Notes: *Counterfactual* refers to the scenario in which the Post-2000 economy is assigned the Pre-2000 lock-in innovation structure by setting  $\tilde{\alpha}_{\text{pre-2000}} = \tilde{\alpha}$ ,  $\tilde{\phi}_{\text{pre-2000}} = \tilde{\phi}$ , and  $\tilde{\psi}_{\text{pre-2000}} = \tilde{\psi}$ . "Markup dispersion" refers to the 75th to 25th percentiles markups ratio.

## 5 Conclusion

This paper introduces a new framework to study the macroeconomic implications of firms' investments in productive and lock-in innovations. While productive innovations lower production costs or enhance product quality, ultimately benefiting customer firms by boosting their sales, lock-in innovations create dependencies that increase switching costs, reduce prod-

uct substitutability, and diminish customer sales. My model bridges standard approaches in the literature by incorporating both forms of innovation, offering novel insights into how firms strategically balance productivity improvements with efforts to increase customer dependency.

The results highlight a significant shift in the nature of innovation since the 2000s, driven by a growing prevalence of lock-in innovations among high-markup firms. Quantitatively, the findings suggest that if the cost of lock-in innovations had remained at pre-2000 levels, the observed increase in aggregate productivity in the post-2000 period would have been 30% higher, median markups would have remained unchanged from pre-2000 levels, and the increase in markup dispersion would have been 83% lower than observed. These results underscore the macroeconomic importance of understanding not just how firms innovate to improve efficiency but also how they leverage lock-in strategies to increase market power.

The analysis contributes to the literature by documenting the rising role of lock-in innovations in shaping market outcomes, particularly in industries reliant on technological compatibility and proprietary ecosystems. The findings suggest that the composition of innovation matters for long-run growth, productivity, and market competition, with the rise in lock-in innovations playing a critical role in shaping the economic landscape of the post-2000s economy.

This paper also lays the foundation for a new research agenda on the macroeconomic implications of lock-in innovations. It raises important policy questions, as the growing reliance on lock-in innovations suggests that policies focused solely on promoting productivity-enhancing innovations may not be sufficient to foster competition and sustainable economic growth. Recent antitrust cases involving major technology firms illustrate the challenges regulators face, with companies accused of developing products so customized or integrated that they limit competitors' ability to enter or remain in the market. Future research could explore how policy interventions targeting product compatibility, interoperability, and switching costs might reduce the negative aggregate effects of lock-in innovations. A deeper understanding of these dynamics will be critical in designing policies that strike the right balance between encouraging innovation and maintaining competitive markets.

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## A Theory Appendix

### A.1 Customer firms problem

For ease of exposition, time subscripts have been omitted where they do not cause ambiguity. The customer firms solves the following static profit maximization problem:

$$\max_{x_s, X_c} P_c X_c - \sum_{s \in \Omega_c} p_s x_s \quad s.t. \quad \sum_{s \in \Omega_c} Y\left(\frac{x_s}{X_c}\right) = 1,$$

with  $Y\left(\frac{x_s}{X_c}\right) \equiv \left(\frac{x_s}{X_c}\right)^{\frac{\gamma_s-1}{\gamma_s}}$  in the case of CRESH technology, but more generally for any  $Y\left(\frac{x_s}{X_c}\right)$ , with  $Y(\cdot) : \mathbb{R}^+ \rightarrow \mathbb{R}^+$  strictly increasing, strictly concave function, that is twice continuously differentiable with  $Y(0) = 0$  and  $Y(1) = 1$ .

The Lagrangian of the customer firms' profit maximization problem is given by:

$$\begin{aligned} \mathcal{L} &= P_c X_c - \sum_{s \in \Omega_c} p_s x_s + \lambda \left[ \sum_{s \in \Omega_c} Y\left(\frac{x_s}{X_c}\right) - 1 \right] \\ [x_s] \quad p_s &= \lambda Y' \left( \frac{x_s}{X_c} \right) \frac{1}{X_c} \\ [X_c] \quad P_c &= \lambda \sum_{s \in \Omega_c} Y' \left( \frac{x_s}{X_c} \right) \left( \frac{x_s}{X_c^2} \right) \end{aligned}$$

Combine the two first order conditions to obtain the inverse demand function:

$$p_s = Y' \left( \frac{x_s}{X_c} \right) P_c D_c, \quad (17)$$

and the demand function:

$$x_s = Y'^{-1} \left( \frac{p_s}{P_c D_c} \right) X_c, \quad (18)$$

with demand index  $D_c \equiv \left[ \sum_{s \in \Omega_c} Y' \left( \frac{x_s}{X_c} \right) \left( \frac{x_s}{X_c} \right) \right]^{-1}$ . Finally, for the CRESH application, substitute  $Y\left(\frac{x_s}{X_c}\right) = \frac{\gamma_{st}-1}{\gamma_{st}} \left(\frac{x_{st}}{X_{ct}}\right)^{\frac{-1}{\gamma_{st}}}$  to obtain the demand function presented in section 2.2.

### A.2 Supplier firms problem

#### A.2.1 Proof of Proposition 1.

*Proof. Cournot Competition.* The profit maximization problem of leader supplier firm  $s$  is given by:

$$\max_{x_s} \left\{ Y' \left( \frac{x_s}{X_c(x_s)} \right) P_c(x_s) D_c(x_s) x_s - \frac{W}{a_s} x_s \right\}$$

With first order condition with respect to  $x_s$ :

$$[x_s] \quad Y'' \left( \frac{x_s}{X_c} \right) \frac{\partial \frac{x_s}{X_c}}{\partial x_s} P_c D_c x_s + Y' \left( \frac{x_s}{X_c} \right) \left[ P_c D_c + x_s \frac{\partial P_c D_c}{\partial x_s} \right] = \frac{W}{a_s}$$

$$Y'' \left( \frac{x_s}{X_c} \right) \frac{\partial \frac{x_s}{X_c}}{\partial x_s} P_c D_c x_s + Y' \left( \frac{x_s}{X_c} \right) \left[ P_c D_c + x_s \frac{\partial P_c}{\partial X_c} \frac{\partial X_c}{\partial x_s} D_c + x_s P_c \frac{\partial D_c}{\partial x_s} \right] = \frac{W}{a_s}$$

$$\begin{aligned}
Y'' \left( \frac{x_s}{X_c} \right) \frac{\partial \frac{x_s}{X_c}}{\partial x_s} x_s \frac{p_s}{Y' \left( \frac{x_s}{X_c} \right)} + Y' \left( \frac{x_s}{X_c} \right) \left[ \frac{p_s}{Y' \left( \frac{x_s}{X_c} \right)} + x_s \frac{\partial P_c}{\partial X_c} \frac{\partial X_c}{\partial x_s} \frac{p_s}{Y' \left( \frac{x_s}{X_c} \right) P_c} + x_s \frac{p_s}{Y' \left( \frac{x_s}{X_c} \right) D_c} \frac{\partial D_c}{\partial x_s} \right] &= \frac{W}{a_s} \\
Y'' \left( \frac{x_s}{X_c} \right) \frac{\partial \frac{x_s}{X_c}}{\partial x_s} x_s \frac{p_s}{Y' \left( \frac{x_s}{X_c} \right)} + Y' \left( \frac{x_s}{X_c} \right) \left[ \frac{p_s}{Y' \left( \frac{x_s}{X_c} \right)} + \frac{p_s}{Y' \left( \frac{x_s}{X_c} \right)} \underbrace{\frac{\partial P_c}{\partial X_c} \frac{\partial X_c}{\partial x_s} \frac{x_s}{P_c}}_{\varepsilon_{P_c, x_s}} + \frac{p_s}{Y' \left( \frac{x_s}{X_c} \right)} \underbrace{\frac{\partial D_c}{\partial x_s} \frac{x_s}{D_c}}_{\varepsilon_{D_c, x_s}} \right] &= \frac{W}{a_s}
\end{aligned} \tag{19}$$

Separately solve:

$$\frac{\partial \frac{x_s}{X_c}}{\partial x_s} x_s = \frac{X_c - x_s \frac{\partial X_c}{\partial x_s}}{X_c^2} x_s = \frac{X_c - x_s \frac{\partial X_c}{\partial x_s}}{X_c} \frac{x_s}{X_c} = \left( 1 - \underbrace{\frac{\partial X_c}{\partial x_s} \frac{x_s}{X_c}}_{\varepsilon_{X_c, x_s}} \right) \frac{x_s}{X_c}$$

Substituting it into (19):

$$\begin{aligned}
Y'' \left( \frac{x_s}{X_c} \right) \left( 1 - \underbrace{\frac{\partial X_c}{\partial x_s} \frac{x_s}{X_c}}_{\varepsilon_{X_c, x_s}} \right) \frac{x_s}{X_c} \frac{p_s}{Y' \left( \frac{x_s}{X_c} \right)} + Y' \left( \frac{x_s}{X_c} \right) \left[ \frac{p_s}{Y' \left( \frac{x_s}{X_c} \right)} + \frac{p_s}{Y' \left( \frac{x_s}{X_c} \right)} \underbrace{\frac{\partial P_c}{\partial X_c} \frac{\partial X_c}{\partial x_s} \frac{x_s}{P_c}}_{\varepsilon_{P_c, x_s}} + \frac{p_s}{Y' \left( \frac{x_s}{X_c} \right)} \underbrace{\frac{\partial D_c}{\partial x_s} \frac{x_s}{D_c}}_{\varepsilon_{D_c, x_s}} \right] &= \frac{W}{a_s} \\
Y'' \left( \frac{x_s}{X_c} \right) (1 - \varepsilon_{X_c, x_s}) \frac{x_s}{X_c} \frac{p_s}{Y' \left( \frac{x_s}{X_c} \right)} + Y' \left( \frac{x_s}{X_c} \right) \left[ \frac{p_s}{Y' \left( \frac{x_s}{X_c} \right)} + \frac{p_s}{Y' \left( \frac{x_s}{X_c} \right)} \varepsilon_{P_c, x_s} + \frac{p_s}{Y' \left( \frac{x_s}{X_c} \right)} \varepsilon_{D_c, x_s} \right] &= \frac{W}{a_s} \\
\frac{p_s}{Y' \left( \frac{x_s}{X_c} \right)} \left\{ Y'' \left( \frac{x_s}{X_c} \right) (1 - \varepsilon_{X_c, x_s}) \frac{x_s}{X_c} + Y' \left( \frac{x_s}{X_c} \right) [1 + \varepsilon_{P_c, x_s} + \varepsilon_{D_c, x_s}] \right\} &= \frac{W}{a_s}
\end{aligned}$$

Which leads to the expression for  $p_s$  in equilibrium:

$$p_s = \frac{W}{a_s} \frac{Y' \left( \frac{x_s}{X_c} \right)}{\underbrace{\left\{ Y'' \left( \frac{x_s}{X_c} \right) \frac{x_s}{X_c} (1 - \varepsilon_{X_c, x_s}) + Y' \left( \frac{x_s}{X_c} \right) [1 + \varepsilon_{P_c, x_s} + \varepsilon_{D_c, x_s}] \right\}}_{\text{markup } \mu_s}} \tag{20}$$

Now solve for the implied elasticity of demand:

$$\begin{aligned}
\mu_s &= \frac{\vartheta}{\vartheta - 1} = \frac{1}{1 - \frac{1}{\vartheta}} = \frac{Y' \left( \frac{x_s}{X_c} \right)}{\left\{ Y'' \left( \frac{x_s}{X_c} \right) \frac{x_s}{X_c} (1 - \varepsilon_{X_c, x_s}) + Y' \left( \frac{x_s}{X_c} \right) [1 + \varepsilon_{P_c, x_s} + \varepsilon_{D_c, x_s}] \right\}} \\
\frac{1}{\vartheta} &= 1 - \frac{\left\{ Y'' \left( \frac{x_s}{X_c} \right) \frac{x_s}{X_c} (1 - \varepsilon_{X_c, x_s}) + Y' \left( \frac{x_s}{X_c} \right) [1 + \varepsilon_{P_c, x_s} + \varepsilon_{D_c, x_s}] \right\}}{Y' \left( \frac{x_s}{X_c} \right)} \\
\frac{1}{\vartheta} Y' \left( \frac{x_s}{X_c} \right) &= Y' \left( \frac{x_s}{X_c} \right) - \left\{ Y'' \left( \frac{x_s}{X_c} \right) \frac{x_s}{X_c} (1 - \varepsilon_{X_c, x_s}) + Y' \left( \frac{x_s}{X_c} \right) [1 + \varepsilon_{P_c, x_s} + \varepsilon_{D_c, x_s}] \right\} \\
\vartheta &= \frac{Y' \left( \frac{x_s}{X_c} \right)}{Y' \left( \frac{x_s}{X_c} \right) - Y'' \left( \frac{x_s}{X_c} \right) \frac{x_s}{X_c} (1 - \varepsilon_{X_c, x_s}) - Y' \left( \frac{x_s}{X_c} \right) [1 + \varepsilon_{P_c, x_s} + \varepsilon_{D_c, x_s}]} \\
\vartheta &= \frac{Y' \left( \frac{x_s}{X_c} \right)}{Y' \left( \frac{x_s}{X_c} \right) [1 - 1 - \varepsilon_{P_c, x_s} - \varepsilon_{D_c, x_s}] - Y'' \left( \frac{x_s}{X_c} \right) \frac{x_s}{X_c} (1 - \varepsilon_{X_c, x_s})}
\end{aligned}$$

$$\begin{aligned}\vartheta &= \frac{Y' \left( \frac{x_s}{X_c} \right)}{Y' \left( \frac{x_s}{X_c} \right) [-\varepsilon_{P_c, x_s} - \varepsilon_{D, x_s}] - Y'' \left( \frac{x_s}{X_c} \right) \frac{x_s}{X_c} (1 - \varepsilon_{X_c, x_s})} \\ \vartheta &= \frac{Y' \left( \frac{x_s}{X_c} \right)}{-Y' \left( \frac{x_s}{X_c} \right) [\varepsilon_{P_c, x_s} + \varepsilon_{D, x_s}] - Y'' \left( \frac{x_s}{X_c} \right) \frac{x_s}{X_c} (1 - \varepsilon_{X_c, x_s})} \\ \vartheta &= - \frac{Y' \left( \frac{x_s}{X_c} \right)}{Y'' \left( \frac{x_s}{X_c} \right) \frac{x_s}{X_c} (1 - \varepsilon_{X_c, x_s}) + Y' \left( \frac{x_s}{X_c} \right) [\varepsilon_{P_c, x_s} + \varepsilon_{D_c, x_s}]}\end{aligned}$$

Rearranging terms, we obtain the equations in Proposition 1:

$$\begin{aligned}\vartheta &= - \left[ \frac{Y'' \left( \frac{x_s}{X_c} \right) \frac{x_s}{X_c}}{Y' \left( \frac{x_s}{X_c} \right)} [1 - \varepsilon_{X_c, x_s}] + [\varepsilon_{P_c, x_s} + \varepsilon_{D_c, x_s}] \right]^{-1} \\ \vartheta &= \left[ - \frac{Y'' \left( \frac{x_s}{X_c} \right) \frac{x_s}{X_c}}{Y' \left( \frac{x_s}{X_c} \right)} [1 - \varepsilon_{X_c, x_s}] + \frac{1}{\eta} \varepsilon_{X_c, x_s} - \varepsilon_{D_c, x_s} \right]^{-1}\end{aligned}\quad (21)$$

where  $\varepsilon_{D_c, x_s} \equiv \frac{\partial D_c}{\partial x_s} \frac{x_s}{D_c}$  and in the last row I used the fact that  $\frac{\partial P_c}{\partial X_c} = -\frac{1}{\eta} X_c^{-\frac{1}{\eta}-1} Y^{\frac{1}{\eta}} P = -\frac{1}{\eta} \frac{P_c}{X_c}$ , and therefore  $\varepsilon_{P_c, x_s} \equiv \frac{\partial P_c}{\partial X_c} \frac{\partial X_c}{\partial x_s} \frac{x_s}{P_c} = -\frac{1}{\eta} \frac{\partial X_c}{\partial x_s} \frac{x_s}{X_c} \equiv -\frac{1}{\eta} \varepsilon_{X_c, x_s}$ .

**Bertrand Competition.** Following the same logic as with Cournot competition, one can prove that the equilibrium elasticity of demand under Bertrand competition is given by:

$$\vartheta = \left[ - \frac{Y' \left( \frac{x_s}{X_c} \right)}{Y'' \left( \frac{x_s}{X_c} \right) \frac{x_s}{X_c}} \left( 1 - \varepsilon_{(P_c D_c), p_s} \right) + \eta \varepsilon_{P_c, p_s} \right] \quad (22)$$

with  $\varepsilon_{(P_c D_c), p_s} \equiv \frac{\partial P_c D_c}{\partial p_s} \frac{p_s}{P_c D_c}$  and  $\varepsilon_{P_c, p_s} \equiv \frac{\partial P_c}{\partial p_s} \frac{p_s}{P_c}$ . □

**Lemma 1.** Market share of supplier firms.

Substituting the customer firm demand for supplier firms goods (18) and the customer firm inverse demand (17) in the definition of supplier firm market share we obtain:

$$S_s \equiv \frac{p_s x_s}{P_c X_c} = \frac{Y' \left( \frac{x_s}{X_c} \right) P_c D_c x_s}{P_c X_c} = \frac{x_s}{X_c} D_c Y' \left( \frac{x_s}{X_c} \right) \quad (23)$$

$$S_s \equiv \frac{p_s x_s}{P_c X_c} = \frac{p_s Y'^{-1} \left( \frac{p_s}{P_c D_c} \right) X_c}{P_c X_c} = \frac{p_s}{P_c} Y'^{-1} \left( \frac{p_s}{P_c D_c} \right) \quad (24)$$

## A.2.2 CRESH application.

**Lemma 2.** Elasticities as functions of market share of supplier firms.

Elasticities  $\varepsilon_{X_c, x_s}$ ,  $\varepsilon_{D_c, x_s}$ ,  $\varepsilon_{(P_c D_c), p_s}$  and  $\varepsilon_{P_c, p_s}$  can be expressed as a function of model parameters and the market share of supplier firms over customer firms:

$$\varepsilon_{X_c, x_s} \equiv \frac{\partial X_c}{\partial x_s} \frac{x_s}{X_c} \equiv \frac{d \log X_c}{d \log x_s} = S_s$$

$$\begin{aligned}
\varepsilon_{D_c, x_s} &\equiv \frac{\partial D_c}{\partial x_s} \frac{x_s}{D_c} \equiv \frac{d \log D_c}{d \log x_s} = \frac{1}{\gamma_s} S_s - \left( \sum_{j \in \Omega_c} S_j \frac{1}{\gamma_j} \right) S_s \\
\varepsilon_{(P_c D_c), p_s} &\equiv \frac{\partial P_c D_c}{\partial p_s} \frac{p_s}{P_c D_c} \equiv \frac{d \log P_c D_c}{d \log p_s} = \frac{\gamma_s S_s}{\sum_{s \in \Omega_c} \gamma_s S_s} \\
\varepsilon_{P_c, p_s} &\equiv \frac{\partial P_c}{\partial p_s} \frac{p_s}{P_c} \equiv \frac{d \log P_c}{d \log p_s} = S_s
\end{aligned}$$

*Proof.* **Cournot competition.**

1.  $\varepsilon_{X_c, x_s}$ :

Differentiating condition  $\sum_{s \in \Omega_c} Y \left( \frac{x_s}{X_c} \right) = 1$ :

$$\begin{aligned}
\sum_{s \in \Omega_c} dY \left( \frac{x_s}{X_c} \right) &= 0 \\
dY \left( \frac{x_s}{X_c} \right) &= Y' \left( \frac{x_s}{X_c} \right) d \frac{x_s}{X_c} \\
&= Y' \left( \frac{x_s}{X_c} \right) \left[ \frac{\partial \frac{x_s}{X_c}}{\partial x_s} dx_s + \frac{\partial \frac{x_s}{X_c}}{\partial X_c} dX_c \right] \\
&= Y' \left( \frac{x_s}{X_c} \right) \left[ \frac{1}{X_c} dx_s + \left( -\frac{1}{X_c^2} \right) x_s dX_c \right] \\
&= Y' \left( \frac{x_s}{X_c} \right) \left[ \frac{1}{X_c} dx_s - \frac{x_s}{X_c} d \log X_c \right] \\
&= Y' \left( \frac{x_s}{X_c} \right) \frac{1}{X_c} dx_s - Y' \left( \frac{x_s}{X_c} \right) \frac{x_s}{X_c} d \log X_c
\end{aligned}$$

Substituting from the definition of market share (23):

$$\begin{aligned}
dY \left( \frac{x_s}{X_c} \right) &= \frac{S_s}{D_c x_s} dx_s - \frac{S_s}{D_c} d \log X_c \\
&= \frac{S_s}{D_c} d \log x_s - \frac{S_s}{D_c} d \log X_c
\end{aligned}$$

Summing across suppliers:

$$\begin{aligned}
0 &= \sum_{s \in \Omega_c} \left( \frac{S_s}{D_c} d \log x_s - \frac{S_s}{D_c} d \log X_c \right) \\
0 &= \frac{1}{D_c} \sum_{s \in \Omega_c} (S_s d \log x_s - S_s d \log X_c) \\
d \log X_c &= \sum_{s \in \Omega_c} S_s d \log x_s \tag{25}
\end{aligned}$$

Which gives the result:

$$\varepsilon_{X_c, x_s} \equiv \frac{\partial X_c}{\partial x_s} \frac{x_s}{X_c} \equiv \frac{d \log X_c}{d \log x_s} = S_s$$

2.  $\varepsilon_{D_c, x_s}$ :

The sum of market shares across suppliers for each customer has to be one:  $\sum_{s \in \Omega_s} S_s = \sum_s \frac{x_s}{X_c} D_c Y' \left( \frac{x_s}{X_c} \right) =$

1. Differentiating this condition:

$$\sum_s d \frac{x_s}{X_c} D_c Y' \left( \frac{x_s}{X_c} \right) = 0$$

$$\underbrace{d \frac{x_s}{X_c} D_c Y' \left( \frac{x_s}{X_c} \right)}_{\equiv G} = \frac{\partial G}{\partial x_s} dx_s + \frac{\partial G}{\partial X_c} dX_c + \frac{\partial G}{\partial D_c} dD_c \quad (26)$$

I now separately derive each term of equation (26). The first term is given by:

$$\frac{\partial G}{\partial x_s} dx_s = \left[ \frac{D_c}{X_c} Y' \left( \frac{x_s}{X_c} \right) + \frac{x_s D_c}{X_c} \frac{\partial Y' \left( \frac{x_s}{X_c} \right)}{\partial \frac{x_s}{X_c}} \frac{\partial \frac{x_s}{X_c}}{\partial x_s} \right] dx_s.$$

Substituting from the definition of market share (23):

$$\begin{aligned} \frac{\partial G}{\partial x_s} dx_s &= \left[ \frac{S_s}{x_s} + \frac{S_s}{Y'} \frac{\partial Y' \left( \frac{x_s}{X_c} \right)}{\partial \frac{x_s}{X_c}} \frac{x_s}{X_c} \frac{1}{x_s} \right] dx_s \\ \frac{\partial G}{\partial x_s} dx_s &= \left[ S_s + S_s \frac{\partial Y' \left( \frac{x_s}{X_c} \right)}{\partial \frac{x_s}{X_c}} \frac{x_s}{X_c} \frac{1}{Y'} \right] d \log x_s \\ \frac{\partial G}{\partial x_s} dx_s &= S_s \left( 1 - \frac{1}{\gamma_s} \right) d \log x_s \end{aligned} \quad (27)$$

where in the last row I have substituted  $\frac{\partial Y' \left( \frac{x_s}{X_c} \right)}{\partial \frac{x_s}{X_c}} \frac{x_s}{X_c} \frac{1}{Y'} = -\frac{1}{\gamma_s}$ .

The second term in equation (26) is given by:

$$\begin{aligned} \frac{\partial G}{\partial X_c} dX_c &= \left[ -\frac{1}{X_c^2} x_s D_c Y' \left( \frac{x_s}{X_c} \right) + \frac{x_s D_c}{X_c} \frac{\partial Y' \left( \frac{x_s}{X_c} \right)}{\partial \frac{x_s}{X_c}} \left( -\frac{x_s}{X_c^2} \right) \right] dX_c \\ &= \left[ -S_s + S_s \frac{\partial Y' \left( \frac{x_s}{X_c} \right)}{\partial \frac{x_s}{X_c}} \frac{x_s}{X_c} \frac{1}{Y'} \right] d \log X_c \\ &= -S_s \left[ 1 - \frac{1}{\gamma_s} \right] d \log X_c \end{aligned} \quad (28)$$

The last term in equation (26) is given by:

$$\frac{\partial G}{\partial D_c} dD_c = Y' \left( \frac{x_s}{X_c} \right) \frac{x_s}{X_c} dD_c = S_s d \log D_c \quad (29)$$

Substituting (27), (28) and (29) in equation (26) and using the previous result from equation (25),

$$d \log X_c = \sum_{s \in \Omega_c} S_s d \log x_s:$$

$$\begin{aligned} 0 &= \frac{\partial G}{\partial x_s} dx_s + \frac{\partial G}{\partial X_c} dX_c + \frac{\partial G}{\partial D_c} dD_c \\ 0 &= \sum_{s \in \Omega_c} \left[ S_s \left( 1 - \frac{1}{\gamma_s} \right) d \log x_s - S_s \left[ 1 - \frac{1}{\gamma_s} \right] d \log X_c + S_s d \log D_c \right] \\ d \log D_c &= \sum_{s \in \Omega_c} \left[ -S_s \left( 1 - \frac{1}{\gamma_s} \right) d \log x_s + S_s \left[ 1 - \frac{1}{\gamma_s} \right] d \log X_c \right] \\ &= - \sum_{s \in \Omega_c} S_s d \log x_s + \sum_{s \in \Omega_c} S_s \frac{1}{\gamma_s} d \log x_s + \sum_{s \in \Omega_c} S_s d \log X_c - \sum_{s \in \Omega_c} S_s \frac{1}{\gamma_s} d \log X_c \\ &= - d \log X_c + d \log X_c + \sum_{s \in \Omega_c} S_s \frac{1}{\gamma_s} d \log x_s - \sum_{s \in \Omega_c} S_s \frac{1}{\gamma_s} d \log X_c \end{aligned}$$

$$= \sum_{s \in \Omega_c} S_s \frac{1}{\gamma_s} d \log x_s - \sum_{s \in \Omega_c} S_s \frac{1}{\gamma_s} d \log X_c$$

It then follows that:

$$\varepsilon_{D_c, x_s} \equiv \frac{\partial D_c}{\partial x_s} \frac{x_s}{D_c} \equiv \frac{d \log D_c}{d \log x_s} = \frac{1}{\gamma_s} S_s - \left( \sum_{j \in \Omega_c} S_j \frac{1}{\gamma_j} \right) S_s.$$

### Bertrand competition

1.  $\varepsilon_{(P_c D_c), p_s}$  :

Using supplier demand (18) and differentiating condition  $\sum_{s \in \Omega_c} Y \left( Y'^{-1} \left( \frac{p_s}{P_c D_c} \right) \right) = 1$ :

$$\begin{aligned} \sum_{s \in \Omega_c} dY \left( Y'^{-1} \left( \frac{p_s}{P_c D_c} \right) \right) &= 0 \\ dY \left( Y'^{-1} \left( \frac{p_s}{P_c D_c} \right) \right) &= Y' \left( Y'^{-1} \left( \frac{p_s}{P_c D_c} \right) \right) dY'^{-1} \left( \frac{p_s}{P_c D_c} \right) \\ &= \underbrace{\frac{p_s}{P_c D_c}}_{\equiv g_s} dY'^{-1} \left( \frac{p_s}{P_c D_c} \right) \\ &= g_s \frac{\partial Y'^{-1}}{\partial g_s} \left[ \frac{\partial g_s}{\partial p_s} dp_s + \frac{\partial g_s}{\partial P_c D_c} dP_c D_c \right] \\ &= g_s \frac{\partial Y'^{-1}}{\partial g_s} \left[ \frac{1}{P_c D_c} dp_s - \frac{p_s}{(P_c D_c)^2} dP_c D_c \right] \\ &= g_s \frac{\partial Y'^{-1}}{\partial g_s} \left[ \frac{1}{P_c D_c} dp_s - \frac{p_s}{P_c D_c} d \log P_c D_c \right] \end{aligned}$$

Substituting from the definition of market share (24):

$$\begin{aligned} dY \left( Y'^{-1} \left( \frac{p_s}{P_c D_c} \right) \right) &= g_s \frac{\partial Y'^{-1}}{\partial g_s} \left[ \frac{S_s}{p_s Y'^{-1}} \frac{1}{D_c} dp_s - \frac{S_s}{Y'^{-1}} \frac{1}{D_c} d \log P_c D_c \right] \\ &= \frac{\partial Y'^{-1}}{\partial g_s} \frac{g_s}{Y'^{-1}} S_s \frac{1}{D_c} d \log p_s - \frac{\partial Y'^{-1}}{\partial g_s} \frac{g_s}{Y'^{-1}} S_s \frac{1}{D_c} d \log P_c D_c \\ &= -\gamma_s S_s \frac{1}{D_c} d \log p_s + \gamma_s S_s \frac{1}{D_c} d \log P_c D_c, \end{aligned}$$

where in the last row I have substituted  $\frac{\partial Y'^{-1}}{\partial g_s} \frac{g_s}{Y'^{-1}} = -\gamma_s$ .

Summing across suppliers:

$$\begin{aligned} \sum_{s \in \Omega_c} dY \left( Y'^{-1} \left( \frac{p_s}{P_c D_c} \right) \right) &= \sum_{s \in \Omega_c} -\gamma_s S_s \frac{1}{D_c} d \log p_s + \gamma_s S_s \frac{1}{D_c} d \log P_c D_c \\ d \log P_c D_c &= \frac{\sum_{s \in \Omega_c} \gamma_s S_s d \log p_s}{\sum_{s \in \Omega_c} \gamma_s S_s} \end{aligned} \tag{30}$$

Therefore:

$$\varepsilon_{(P_c D_c), p_s} \equiv \frac{\partial P_c D_c}{\partial p_s} \frac{p_s}{P_c D_c} \equiv \frac{d \log P_c D_c}{d \log p_s} = \frac{\gamma_s S_s}{\sum_{s \in \Omega_c} \gamma_s S_s}.$$

2.  $\varepsilon_{P_c, p_s}$  :

The sum of market shares across suppliers for each customer has to be one, that is,  $\sum_{s \in \Omega_s} S_s = \sum_s \frac{p_s}{P_c} Y'^{-1} \left( \frac{p_s}{P_c D_c} \right) = 1$ . Differentiating this condition:

$$\sum_s d \frac{p_s}{P_c} Y'^{-1} \left( \frac{p_s}{P_c D_c} \right) = 0$$

$$\underbrace{d \frac{p_s}{P_c} Y'^{-1} \left( \underbrace{\frac{p_s}{P_c D_c}}_{\equiv g_s} \right)}_{\equiv G_s} = \frac{\partial G_s}{\partial p_s} dp_s + \frac{\partial G_s}{\partial P_c} dP_c + \frac{\partial G_s}{\partial Y'^{-1}} \frac{\partial Y'^{-1}}{\partial g_s} dg_s$$

$$dG_s = \frac{1}{P_c} Y'^{-1}(g_s) dp_s + \left( -\frac{1}{P_c^2} \right) p_s Y'^{-1}(g_s) dP_c + \frac{p_s}{P_c} \frac{\partial Y'^{-1}}{\partial g_s} \left[ \frac{1}{P_c D_c} dp_s - \frac{p_s}{P_c D_c} d\log P_c D_c \right]$$

Substituting from the definition of market share (24):

$$\begin{aligned} \underbrace{d \frac{p_s}{P_c} Y'^{-1} \left( \underbrace{\frac{p_s}{P_c D_c}}_{\equiv g_s} \right)}_{\equiv G_s} &= S_s d\log p_s - S_s d\log P_c + \frac{S_s}{Y'^{-1}} \frac{\partial Y'^{-1}}{\partial g_s} \left[ \frac{p_s}{P_c D_c} d\log p_s - \frac{p_s}{P_c D_c} d\log P_c D_c \right] \\ &= S_s d\log p_s - S_s d\log P_c - S_s \gamma_s d\log p_s + S_s \gamma_s d\log P_c D_c \end{aligned}$$

where in the last row I have substituted  $\frac{\partial Y'^{-1}}{\partial g_s} \frac{g_s}{Y'^{-1}} = -\gamma_s$ .

Summing across suppliers and substituting for  $d\log P_c D_c$  from (30):

$$\begin{aligned} 0 &= \sum_{s \in \Omega_c} S_s d\log p_s - \sum_{s \in \Omega_c} S_s d\log P_c - \sum_{s \in \Omega_c} S_s \gamma_s d\log p_s + \sum_{s \in \Omega_c} S_s \gamma_s d\log P_c D_c \\ d\log P_c &= \sum_{s \in \Omega_c} S_s d\log p_s - \sum_{s \in \Omega_c} S_s \gamma_s d\log p_s + \sum_{s \in \Omega_c} S_s \gamma_s \frac{\sum_{s \in \Omega_c} \gamma_s S_c d\log p_s}{\sum_{s \in \Omega_c} \gamma_s S_s} \\ &= \sum_{s \in \Omega_c} S_s d\log p_s \end{aligned}$$

It then follows that:

$$\varepsilon_{P_c, p_s} \equiv \frac{\partial P_c}{\partial p_s} \frac{p_s}{P_c} \equiv \frac{d\log P_c}{d\log p_s} = S_s.$$

□

**Corollary 2.** When customer firm  $c$  produce with a CRESH production function  $Y\left(\frac{x_s}{X_c}\right) = \left(\frac{x_s}{X_c}\right)^{\frac{\gamma_s-1}{\gamma_s}}$ , the elasticity of demand of a supplier firm  $s$  in equilibrium is given by:

$$\begin{aligned} \vartheta_s^C &= \left[ \frac{1}{\gamma_s} (1 - S_s) + \frac{1}{\eta} S_s + \left( \sum_{j \in \Omega_c} S_j \frac{1}{\gamma_j} - \frac{1}{\gamma_s} \right) S_s \right]^{-1} \text{ if Cournot competition,} \\ \vartheta_s^B &= \left[ \gamma_s \left( 1 - \frac{\gamma_s S_s}{\sum_{s \in \Omega_c} \gamma_s S_s} \right) + \eta S_s \right] \text{ if Bertrand competition.} \end{aligned}$$

*Proof.* The demand elasticities in equilibrium are obtained from combining equations (22) and (21) with the result that under CRESH  $\frac{Y'(\frac{x_s}{X_c})}{Y''(\frac{x_s}{X_c}) \frac{x_s}{X_c}} = \gamma_s$ , and with the elasticities derived in Lemma 2. □



**Table 10: General Framework Applications**

|  | monopolistic competition  | oligopolistic competition (Bertrand)  |   |  |
|--|---|---|---|--|
|  | Kimball<br>Klenow & Willis (2016)   | CES   | CES<br>Atkeson & Burstein (2008)  | CRESH<br>This paper  |
| $Y\left(\frac{x_s}{X_c}\right)$ function | $Y' = \frac{\gamma-1}{\gamma} \exp\left(\frac{1-\frac{x_s}{X_c}}{\frac{\gamma}{\gamma-1}}\right)$ | $Y = \left(\frac{x_s}{X_c}\right)^{\frac{\gamma-1}{\gamma}}$                        | $Y = \left(\frac{x_s}{X_c}\right)^{\frac{\gamma-1}{\gamma}}$                        | $Y = \left(\frac{x_s}{X_c}\right)^{\frac{\gamma_s-1}{\gamma_s}}$                               |
| $X_c$ production                         | $\int_{S_c} Y\left(\frac{x_s}{X_c}\right) ds = 1$   | $X_c = \left(\sum_s x_s^{\frac{\gamma-1}{\gamma}}\right)^{\frac{\gamma}{\gamma-1}}$ | $X_c = \left(\sum_s x_s^{\frac{\gamma-1}{\gamma}}\right)^{\frac{\gamma}{\gamma-1}}$ | $\sum_s Y\left(\frac{x_s}{X_c}\right) = 1$   |
| $\theta_s$ elasticity<br>of demand       | $\gamma \frac{x_s}{X_c}^{-\frac{\gamma}{\gamma-1}}$   | $\gamma$  | $\gamma(1 - S_s) + \eta S_s$  | $\gamma_s \left(1 - \frac{\gamma_s S_s}{\sum_{s \in \Omega_c} \gamma_s S_s}\right) + \eta S_s$ |

Notes: General model applications to non-CES and CES demand, under monopolistic and oligopolistic competition between supplier firms.

## B Quantitative Appendix

### B.1 Algorithm to compute Static Profits

1. First, make a guess of the initial value of firm's prices that is equal to a constant markup over marginal cost:

$$p_s^0 = \frac{\gamma_s}{\gamma_s - 1} \frac{W}{a_s}$$

for  $s = \{Leader, Follower\}$ , and  $\mu_s^0 = \frac{\gamma_s}{\gamma_s - 1}$  being the initial markup.

2. Given  $p_s^0$ , obtain the initial values of equilibrium values of customer firm price  $P_c^0$  and demand aggregator  $D_c^0$ , by solving the system of equations given by condition (31) that states that market shares across suppliers of a given customer have to sum to one, and condition (32) that states that sum of Y function across suppliers of the same customer is one:

$$\sum_s S_s = \sum_s \frac{p_s}{P_c} Y'^{-1} \left( \frac{p_s}{P_c D_c} \right) = 1 \quad (31)$$

$$\sum_s Y\left(\frac{x_s}{X_c}\right) = \sum_s Y \left[ Y'^{-1} \left( \frac{p_s}{P_c D_c} \right) \right] = 1 \quad (32)$$

- (a) For the application of this paper, in which  $Y\left(\frac{x_s}{X_c}\right) = \left(\frac{x_s}{X_c}\right)^{\frac{\gamma_s-1}{\gamma_s}}$ , these conditions are:

$$\sum_s \frac{p_s}{P_c} \left( \frac{p_s}{P_c D_c} \frac{\gamma_s}{\gamma_s - 1} \right)^{-\gamma_s} = 1$$

$$\sum_s \left( \frac{p_s}{P_c D_c} \frac{\gamma_s}{\gamma_s - 1} \right)^{1-\gamma_s} = 1$$

3. Given  $p_s^0, P_c^0$  and  $D_c^0$  we can compute the initial market share of each supplier firm  $s$  in equilibrium  $S_s^0$  from:

$$S_s = \frac{p_s}{P_c} \left( \frac{p_s}{P_c D_c} \frac{\gamma_s}{\gamma_s - 1} \right)^{-\gamma_s}$$

4. Now we are ready to iterate over values the market share with initial values  $p_s^0, P_c^0$  and  $D_c^0, S_s^0$ . The iteration steps are:
5. For a given competition type (Cournot or Bertrand), compute the elasticity of demand in equilibrium given by:

$$\begin{aligned} \vartheta_s^C &= \left[ \frac{1}{\gamma_s} (1 - S_s) + \frac{1}{\eta} S_s + \left( \sum_{j \in \Omega_c} S_j \frac{1}{\gamma_j} - \frac{1}{\gamma_s} \right) S_s \right]^{-1} \text{ if Cournot competition} \\ \vartheta_s^B &= \left[ \gamma_s \left( 1 - \frac{\gamma_s S_s}{\sum_{s \in \Omega_c} \gamma_s S_s} \right) + \eta S_s \right] \text{ if Bertrand competition} \end{aligned}$$

6. Having computed  $\vartheta$ , we can now compute the markups in equilibrium as:

$$\mu_s = \frac{\vartheta_s}{\vartheta_s - 1}$$

7. Update the new value of the markup to be  $\mu_s^{new} = \mu_s^0 + 0.5 * (\mu_s - \mu_s^0)$
8. Compute the new value of the firm's price as  $p_s^{new} = \mu_s^{new} \frac{W}{a_s}$
9. Given  $p_s^{new}$ , repeat step 2. to compute the new values of  $P_c^{new}$  and  $D_c^{new}$  in equilibrium.
10. Given  $p_s^{new}, P_c^{new}$  and  $D_c^{new}$  repeat step 3. to compute the new market shares  $S_s^{new}$ .
11. Update  $\mu^0 = \mu^{new}$  and  $S_s^0 = S_s^{new}$ , and iterate until convergence.
12. Once converged, we have the values of  $\mu_s, S_s, p_s, P_c, D_c$  in equilibrium. Given values of aggregate prices and GDP  $P$  and  $Y$ , now we can compute the customer firm production  $Y_c$  from the demand function of the customer firm given by:

$$X_c = \left( \frac{P_c}{P} \right)^{-\eta} Y$$

13. The production of the supplier firm  $x_s$  is given by the demand function:

$$x_s = Y'^{-1} \left( \frac{p_s}{P_c D_c} \right) X_c = \left( \frac{p_s}{P_c D_c} \frac{\gamma_s}{\gamma_s - 1} \right)^{-\gamma_s} X_c$$

## B.2 Algorithm for Value Function Iteration

Parameters

- preferences  $\rho$
- innovation  $i$ :  $(\Delta, \alpha_i, \phi_i)$  and  $a_{\max} = -a_{\min}$  bounds of the productivity grid
- elasticity  $i$ :  $(\delta, \alpha_z, \phi_z)$  and  $(\gamma_F, \gamma_{\min})$  bounds of the elasticity grid

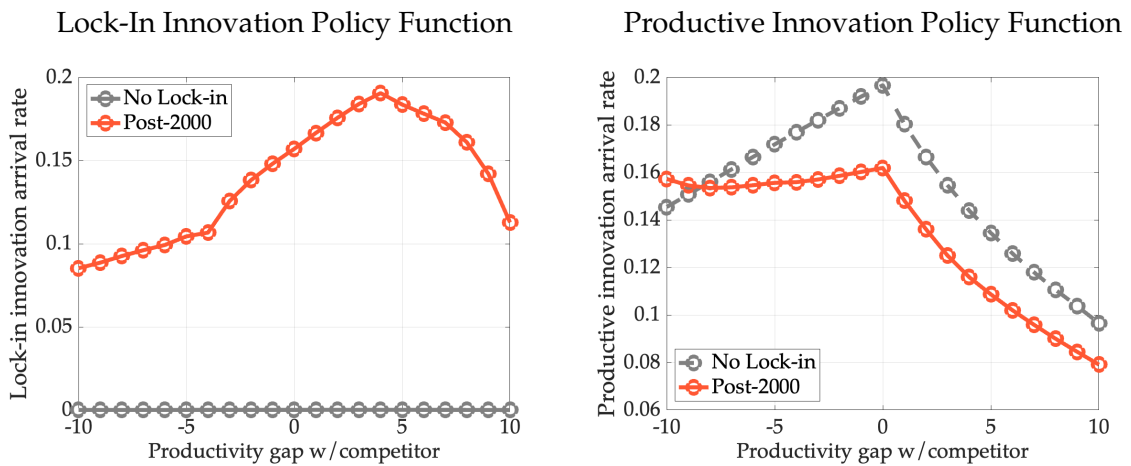
- production technology:
- aggregate:  $(P, Y, W)$  are given for an industry, and  $\eta$  is the elasticity of substitution between customers
- other: set  $dt = 1/50$ .

VFI

1. Guess value  $\{V_N, V_F, V_L\}$
2. Compute policy functions
3. Using policy functions compute HJB and update values of  $\{V_N, V_F, V_L\}$ . Check distance, if far enough then continue to step 2 with updated guesses.

### B.3 Counterfactual Exercises

**Figure 15:** Innovation Policy Functions: No Lock-in Scenario



Notes: calibrated model lock-in (panel (a)) and productive (panel (b)) innovations' policy functions, against the supplier's productivity gap (in terms of number of steps) with respect to their competitor, for the *Baseline* Post-2000 calibrated economy, compared to the *Without Lock-in* counterfactual economy with infinitely costly lock-in innovations.

## C Empirical Appendix

**Table 11:** Markups and Product Specificity

|                     | <b>R&amp;D Sales Share</b> | <b>Patents' Citations</b> |
|---------------------|----------------------------|---------------------------|
| High Markup Firm    | 0.822***<br>(0.0299)       | 0.355***<br>(0.0299)      |
| $R^2$               | 0.571                      | 0.468                     |
| Sector & quarter FE | yes                        | yes                       |
| Control for size    | yes                        | yes                       |

Note: High-markup Firm refers to those firms in the sample that belong to the 80th or higher percentile of markups distribution.

**Table 12:** Markups and the Importance of Innovations

|                        | <b>Breakthrough<br/>5-years</b> | <b>Breakthrough<br/>10-years</b> |
|------------------------|---------------------------------|----------------------------------|
| High Markup Firm Diff. | 0.0754***<br>(0.00114)          | 0.0627***<br>(0.00107)           |
| Avg - Low Markup Firm  | 0.119***<br>(0.00209)           | 0.102***<br>(0.00196)            |
| $R^2$                  | 0.160                           | 0.181                            |
| Technological class FE | yes                             | yes                              |
| Quarter FE             | yes                             | yes                              |
| Control for size       | yes                             | yes                              |

Note: High-markup Firm refers to those firms in the sample that belong to the 80th or higher percentile of markups distribution.