

Competition, Uncertainty, and Misallocation *

Abstract

Uncertainty delays investment that involves disruption cost or time-to-build, resulting in capital misallocation from the static point of view. However, theory predicts that uncertainty will affect investment, and hence static misallocation, depending on the degree of product market competition. Using a large panel dataset of manufacturing plants in Japan, we find that although uncertainty results in static misallocation, the effect is weaker for industries with less severe product market competition. We further find that competition worsens uncertainty-driven misallocation through the misallocation among firms that invested in the previous year (*the active margin*) rather than among those that did not (*the inactive margin*). While competition increases the probability of investment, it increases the variability of the optimal level of capital as well, which worsens misallocation. To improve allocative efficiency, reduced uncertainty complements competition policies.

JEL Classification: O11, O47.

Keywords: Uncertainty, Competition, Misallocation.

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