

# 1 Introduction

Among the many dimensions along which the agents' heterogeneity can affect market demand, income heterogeneity is surely a crucial one. The relationship between the personal income distribution and market demand is usually studied, by pointing out how distributional changes yield their effects *via* the shape of the consumers' Engel curves – which of course implies emphasis on the size of the market for a given price level (e.g., Lambert and Pfähler, 1997).

In this paper we take a different approach, by emphasizing how income distribution affects also the sensitivity of demand to price changes. This focus on the price elasticity of demand allows to draw some general relationship between the behaviour of firms in noncompetitive markets, and some key features of the distribution of income. The degree of market power (as measured by the standard Lerner index) turns out to depend on such factors as the weight of the 'middle' class and, more generally, the degree of income dispersion. In particular, under fairly general conditions we show that, as incomes become more concentrated around the given mean, market demand and its elasticity both increase for a relevant intermediate range of prices. In this sense, the existence of a large middle class may support a more competitive market environment, conducive to lower monopoly profits. A related implication is that distributive changes can provide an example of a demand shift, able to deliver a negative comovement of demand and mark-up levels – an issue widely debated both in the micro and the macro literature.

Beyond the theoretical interest of studying the link between income dispersion and market competitiveness, our results may contribute to the debate on the implications of the well known phenomena of income polarization and 'shrinking middle class', which characterized several countries over the last two decades<sup>1</sup> – in some markets, income polarization may account for wider allocative inefficiencies.

The paper is organized as follows. In Section 2 we formalize distributive changes in terms of mean preserving spreads of the income distribution, and build a simple discrete-choice demand model. The co-movements of demand and price elasticity are studied in Section 3, where we rely upon some properties of the so-called income share elasticity function. Section 4 presents a fully developed example, based on the lognormal distribution. Some final comments are gathered in Section 5.

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<sup>1</sup>For recent assessments of increasing income inequality and polarization, see, e.g., Atkinson (1998), Gottschalk and Smeeding (2000), and Pearson and Förster (2000).