Verti-zontal differentiation in export markets

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Abstract

Many trade models of monopolistic competition identify cost efficiency as the main determinant of firm performance in export markets. To date, the analysis of demand factors has received much less attention. We propose a new model where consumer preferences are asymmetric across varieties and heterogeneous across countries. The model generates new predictions and allows for an identification of horizontal differentiation (taste) clearly distinguished from vertical differentiation (quality). Data patterns observed in Belgian firm–product level exports by destination are congruent with the predictions and seem to warrant a richer modelling of consumer demand.

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1. Introduction

Many existing trade models of monopolistic competition identify cost efficiency as the main determinant of firm performance in export markets. In contrast, the analysis of demand factors has received less attention. Demand is typically assumed to be symmetric across varieties and countries. This symmetry in demand is imposed on very different products sold within the same country as well as for the same goods sold across different countries. These restrictive assumptions have led scholars to introduce random shocks to match features of the data.1

The purpose of this paper is to relax the symmetric demand assumption in a love-for-variety trade model by allowing consumers in export markets to differ in two major respects. First, the demand function is allowed to vary across varieties within a destination country. This asymmetry in demand is imposed on very different products sold within the same country as well as for the same goods sold across different countries. These restrictive assumptions have led scholars to introduce random shocks to match features of the data.1

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1 Bernard et al. (2011), Hallak and Sivadasan (2013) and Munch and Nguyen (forthcoming).

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1 Bernard et al. (2011), Hallak and Sivadasan (2013) and Munch and Nguyen (forthcoming).
are heterogeneous in taste. For example, the demand for Heineken can be stronger than the demand for Budweiser in one country, but it can be the opposite in another country where both beers are also sold.

Although firm heterogeneity in efficiency has empirically been confirmed to be very important in explaining firms’ entry into export markets, this seems less the case for firm-level sales variation in different countries conditioning upon entry. Several papers analyzing the variability in firm-level prices and sales across a range of export destinations have reached the conclusion that cost factors alone cannot account for all the variation in the data and conclude that demand factors are important too. In this paper we aim to rationalize the observed firm-destination variation by supplementing firm heterogeneity in costs with consumer heterogeneity. We do so by allowing each destination country to have a different set of asymmetric preferences over the varieties on offer. This is achieved in a simple and intuitive way in the quadratic utility used by Ottaviano et al. (2002), Melitz and Ottaviano (2008), and others. We build the model in two steps. We first introduce asymmetry in preferences across varieties within one country. Next, we allow every country to be characterized by a different set of asymmetric preferences across varieties. Hence, each variety has a country-specific demand, which offers an explanation for the strong variation observed in the quantities of identical varieties sold in various countries.

It is important to point out that varying variety–country sales need not result from market size differences nor from income differences, but from asymmetric preferences between varieties and taste heterogeneity across countries. Put differently, whereas in Melitz and Ottaviano (2008) firm–product–quantity variation across destinations may result from varying market size or from a varying number of competing varieties by destination, the new preferences introduced here show that even when exporting to a country of similar size, similar income level and the same number of competing varieties, quantities shipped may still vary due to taste differences affecting the market outcome in a way that has not been considered before.

In addition to firm–product heterogeneity in cost and taste, we also allow consumer preferences to be asymmetric in quality differences between varieties. Without quality differentiation, the model would wrongly attribute the high sales of high priced varieties within a country entirely to taste differences, which is unlikely. Since quality also affects demand, it should be incorporated in the model in order to allow for a correct identification of taste effects. The model does not impose any correlation between cost, taste and quality but allows these parameters to move freely and independently of each other. For example, we do not impose any relationship between marginal cost and the quality of a variety, thus allowing higher quality to either stem from investments in research and development or from the use of higher-quality and more expensive inputs. Nor do we impose a relationship between taste and quality. Thus, while both quality and taste affect the demand for a variety, they may work in opposite directions. The demand for a variety is thus ultimately determined by the interplay of the quality and taste.

Clear definitions of horizontal and vertical differentiation until now only exist in discrete choice models with indivisible varieties and with consumers making mutually exclusive choices, used in Industrial organization (Tirole, 1988) and, more recently, in trade (Khandelwal, 2010; Fajgelbaum et al., 2011). Discrete choice models incorporate both types of differentiation (Anderson et al., 1992). In contrast, a clear distinction between horizontal (taste) and vertical (quality) differentiation is largely absent in models where consumers have a love-for-variety and purchase many products in varying quantities. This is what we aim to accomplish in this paper where we propose love-for-variety preferences that include horizontal and vertical differentiation, which we refer to as verti-zontal preferences. Typically, varieties of the same good are horizontally differentiated when there is no common ranking across consumers when varieties are equally priced. In other words, horizontal differentiation reflects consumers’ tastes that affect how much firms can sell of each variety. In contrast, varieties are vertically differentiated when all consumers agree on their ranking, and thus quality affects prices in all destination countries.

Unlike discrete choice models, we do not aggregate utility over individual consumers within a country but instead work with a representative consumer per country. This approach is predominantly data driven since shipments in trade by firm–product are typically only available at destination country-level. Our model is not unique in explaining the quantity variation observed in the data, but we will discuss why it is the single one to explain the joint variation in price and quantity of exported firm–products in the data (Section 4.3). The introduction of asymmetries in quadratic utility and of heterogeneity across representative consumers results in a number of appealing features.

First, horizontal differentiation in our model is captured by one single parameter that varies across varieties and consumers for which we provide a micro-foundation that goes back to spatial models of product differentiation à la Hotelling (1929). This approach allows us to determine precisely how this parameter affects demand and sales asymmetrically. This concurs with Vogel (2008) who developed a Hotelling-like model with cost-heterogeneous firms and showed that firms choose asymmetric locations in the linear city model. Therefore, the model we propose in this paper may be viewed as an attempt at reconciling Chamberlin and Hotelling.

Second, our analysis generalizes quasi-linear preferences to introduce demand heterogeneity in a way that permits a separate identification of horizontal and vertical differentiation in a particular sense: the consumer-specific parameter of horizontal differentiation only affects equilibrium quantities but not prices. Thus, horizontal differentiation can be separated from vertical differentiation at the firm–product–country level and can empirically be distinguished by any researcher with access to data on firm characteristics. Horizontal differentiation in CES models cannot explain variation in sales for the same firm–product across countries because the elasticity of substitution is constant across varieties. To remedy for this, one can introduce a firm–product specific demand shock per country that accounts for sales variation of the same firm–product across countries without affecting prices. Horizontal differentiation between products is then the combination of a constant parameter of substitution and a variable shock at the firm–product level. Because the parameter of substitution also enters the price equation, a clear separation of horizontal and vertical differentiation is difficult to attain with the CES. Therefore we need a set of preferences which allows for a clear separation of quality and taste since both shift demand in different ways. Otherwise quality differences between varieties could be confounded with taste differences, and vice versa. In this paper we show that taste differences can shift demand without affecting price, while quality differences always imply a price change.

Third, asymmetric preferences in quadratic utility also result in a richer set of country-specific competition effects. With symmetric preferences, competition effects are a sole function of the number of firms in the destination country, which depends on market size. Allowing for asymmetric preferences generates competition effects that now also depend on the quality of the varieties on offer in the destination country and their interaction with local tastes. In addition, allowing for consumer heterogeneity across countries implies that two countries of similar size and GDP can still be subject to varying levels of competition. Even when the quality on offer in these two countries is the same, competition effects can differ because in one country high quality varieties...
meet better local tastes. Allowing for asymmetric preferences in quality and taste across varieties and taste heterogeneity across countries also generates market structures varying from monopoly to perfect competition. This is shown by defining several market aggregates, which together capture the extent of country-specific competition effects. All in all, the new preferences presented here provide a link to the industrial organization literature where market structure is more central than in standard trade models.

Fourth, our main objective is to better describe consumers’ choices. Selection issues and zero trade flows in exports, whose importance have recently been discussed in the trade literature (e.g. Helpman et al., 2008), do not alter the main message of this paper. In other words, a richer supply side and various entry settings can be added to our model without changing our main results. Heterogeneous consumers across countries with asymmetric preferences across varieties suffice to rationalize the observed export prices and quantities of individual varieties shipped across countries. We disregard market participation issues because our results hold for any number of varieties present in destination countries and any distribution of the quality and taste parameters.

Last, since the parameters stem directly from the utility function, we can provide a clear micro-foundation for them, which improves upon our model without changing our main results. Heterogeneous consumers across countries with asymmetric preferences across varieties suffice to rationalize the observed export prices and quantities of individual varieties shipped across countries. We disregard market participation issues because our results hold for any number of varieties present in destination countries and any distribution of the quality and taste parameters.

Our empirical analysis aims to verify whether the data are consistent with the verti-zontal model. For this purpose we use a cross-sectional analysis of firm–product exports by destination shipped from Belgium, where products are available at the 8-digit level. While our data may suffer from measurement error, especially in quantities, several robustness checks are carried out to minimize its role. The findings are congruent with the verti-zontal model. However, we acknowledge that alternative explanations may also be at work. While taste differences offer a plausible explanation for an empirical regularity hitherto not well understood, future work should be aimed at disentangling taste effects from other potential explanations. A full identification of the model’s parameters would require a much richer dataset and is left for future research.

The next section first discusses the standard quadratic utility before introducing the new consumer preferences. Section 3 discusses market equilibria and parameter identification. Section 4 uses firm–product level cross-sectional exports data for Belgium to explore data patterns. Section 5 concludes.

2. The consumer program

2.1. The standard quadratic utility

Consider an economy endowed with a set I of consumers and two goods – a differentiated good supplied as a continuum S of varieties and the numéraire. In the existing literature using the quadratic utility, consumers share the same preferences given by

{eq}
U = \alpha \int_s q(s)ds - \frac{\beta}{2} \int_s [q(s)]^2ds - \frac{\gamma}{2} \int_s q(s)ds^2 + q_0.
\end{eq}

(1)

In this expression, the utility depends on the consumption q(s) of variety s belonging to a set S of differentiated varieties and on the consumption q_0 of the numéraire. The parameter \( \alpha > 0 \) captures the preference for the differentiated good with respect to the numéraire, while \( \gamma > 0 \) is the degree of substitutability between any pair of varieties in S. A higher \( \gamma \) means that varieties are closer substitutes. The quadratic utility function exhibits a love for variety whose intensity is measured by the value of the parameter \( \beta > 0 \). An important property of Eq. (1) is that the three parameters are identical for all varieties. Thus, two implicit assumptions are made. First, all varieties face the same demand in each country. Second, any particular variety faces the same demand no matter which country it is sold in. In other words, all varieties enter consumer preferences symmetrically around the world, which is clearly restrictive. In terms of our beer example, symmetric preferences amounts to assuming that Heineken and Budweiser face exactly the same demand within a country and this in every country they are sold in.

2.2. The quadratic utility with verti-zontal preferences

We now relax the symmetry assumption within a country, but continue to assume homogeneous consumers across countries. In terms of our beer example, this means that we allow varieties Heineken and Budweiser to face a different demand within a country, depending on their quality and the taste for them, but the demand for each individual beer variety is the same across countries. As such the extent to which each beer is liked (or disliked) is the same for all consumers. In Subsection 2.4, where we introduce heterogeneous consumers, the preference of one beer over another is also allowed to vary by country. Under asymmetric preferences, but with homogeneous consumers everywhere, the quadratic utility (1) is extended as follows:

{eq}
U = \int_s \alpha(s)q(s)ds - \frac{1}{2} \int_s [\beta(s)q(s)]^2ds - \frac{1}{2} \int_s q(s)ds^2 + q_0.
\end{eq}

(2)

The quadratic utility (2) differs from Eq. (1) by the fact that parameters \( \alpha \) and \( \beta \) now depend on \( s \), which indicates that they are variety-specific. Units in which varieties are measured are the same, kilograms of chocolate, bottles of beer and the like. So, we compare one unit of each variety with one unit of another. While notationally Eqs. (2) and (1) may not appear all that different, Eq. (2) represents a very different set of preferences. To justify Eq. (2), we find it is important to offer a clear interpretation for the parameters and do so by discussing their micro-foundations in detail. We first show that \( \beta(s) \) captures the idea of "taste mismatch" between the consumer and variety \( s \), thus characterizing the extent of idiosyncratic horizontal differentiation across varieties.

2.2.1. Taste mismatch (\( \beta(s) \))

In the product characteristics space, the distance to the shop reflects taste mismatch between a consumer’s ideal variety and the one on offer in the shop’s location. Introducing love-for-variety into Hotelling’s (1929) model by giving the consumer a utility function as in Eq. (2), as the consumers are allowed to visit more than one shop, we can also show that the parameter \( \beta(s) \) corresponds to the distance that a consumer has to travel to reach the shop. As a result, we can interpret \( \beta(s) \) in Eq. (2) as a parameter expressing the mismatch between the horizontal characteristics of variety \( s \) and this consumer’s ideal. Thus, we show that the definition of horizontal differentiation in the context of indivisible varieties, with consumers making mutually exclusive choices, concurs with the definition of horizontal differentiation in preferences where consumers buy more than one variety and the

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4 Different from Ottaviano et al. (2002), the parameter \( \beta \) used here captures the degree of horizontal differentiation net of the substitutability among varieties.

5 Normalizing \( \alpha \) to 1 in Eq. (1) is not a problem. By contrast, when \( \alpha \) is variety-specific as in Eq. (2), normalizing \( \alpha(s) \) to 1 is problematic because we may end up with variety-specific units, e.g., kilograms for some varieties and tons for the others, which is not meaningful. In the empirical section, we always measure quantities in the same unit.
differentiated goods are divisible. By drawing a parallel between the taste parameter $\beta(s)$ and the distance a consumer has to travel to a shop, like in the Hotelling setting, we get a clear interpretation for this parameter. This spatial metaphor, which is important for the microfoundation of the parameter in $\beta(s)$ (Eq. (2)), is developed in detail in the appendix.\footnote{Another interpretation of $\beta(s)$ is related to the concavity of the variety-specific utility function. As the mismatch between variety $s$ and the consumer’s ideal increases, it is natural to expect the consumer’s marginal utility to decrease faster. This can be seen by differentiating Eq. (2) with respect to $q(s)$.}

### 2.2.2. Quality ($\alpha(s)$)

The parameter $\alpha$ in both Eqs. (1) and (2) corresponds to consumers’ willingness-to-pay (WTP) for the first unit of variety $s$ in the absence of substitutable varieties. While in the standard quadratic utility, as for example in Eq. (1), the quality of all varieties is assumed to be the same, in Eq. (2) we now allow the quality of each variety to be unique. To better explain the interpretation of $\alpha(s)$, consider the case of two varieties, $s$ and $r$, whose degree of substitutability is captured by the parameter $\gamma > 0$. In this case, a consumer’s utility is equal to

$$U = \alpha(s)q(s) - \frac{\beta(r)}{2}q(s)^2 + \alpha(r)q(r) - \frac{\beta(r)}{2}q(r)^2 - \frac{\gamma}{2}q(r)q(s) + q_0.$$  

(3)

In Eq. (3), $\alpha(s) - \gamma q(r)/2$ is the marginal utility derived from consuming an arbitrarily small amount of variety $s$ when $q(r)$ units of variety $r$ are consumed. This marginal utility varies inversely with the consumption of the other variety because the consumer has a lower valuation for variety $s$ when her consumption of its substitute $r$ is larger. Note that the intercept $\alpha(s) - \gamma q(r)/2$ of the demand function for variety $s$ is positive provided that its desirability ($\alpha(s)$) dominates the negative impact of the consumption of the other variety, $q(r)$, weighted by the degree of substitutability between the two varieties ($\gamma$).

The budget constraint is

$$p(r)q(r) + p(s)q(s) + q_0 = y$$

where $p(r)$ and $p(s)$ are the prices of varieties $r$ and $s$ respectively, and $y$ is income. Plugging the budget constraint in Eq. (3) and differentiating with respect to $q(s)$ yields the inverse demand for variety $s$:

$$p(s) = \alpha(s) - \frac{\gamma}{2}q(r) - \beta(s)q(s).$$

(4)

### 2.2.3. Substitutability ($\gamma$)

This brings us to the parameter $\gamma$. Allowing it to vary across varieties, while analytically feasible, would be cumbersome and difficult to measure empirically as it would amount to identifying a level of substitutability for each and every pair of varieties in the market. We thus follow a pragmatic approach and assume the degree of substitutability between varieties to be defined at the product level and not to vary across varieties of this product. Thus, we allow the beer market to have a different $\gamma$ than the chocolates market, but we assume $\gamma$ between beer varieties to be the same. In terms of our beer example, parameter $\gamma$ captures the fact that Heineken and Budweiser are similarly imperfect substitutes in every country where they are sold, but the parameters $\alpha(s)$ and $\beta(s)$ allow Heineken and Budweiser to enter consumer preferences differently in every country they are sold in. While this is a simplification that should be pointed out, it seems a plausible one. The analytical benefit of keeping $\gamma$ constant will become clear when we discuss competition effects.

### 2.3. Consumer optimization

Let us now proceed with the maximization of the utility in Eq. (2) when a consumer faces the set $S$ of varieties. Plugging the budget constraint

$$\int_S p(s)q(s)ds + q_0 = y$$

in Eq. (2) and differentiating with respect to $q(s)$ yields the inverse demand for variety $s$:

$$p(s) = \alpha(s) - \frac{\gamma}{2}Q - \beta(s)q(s)$$

(5)

where

$$Q = \int_s q(r)dr$$

is the per-capita total consumption of the differentiated good, which acts as a demand shifter for variety $s$. Note that $\alpha(s)$ also shifts the intercept of the inverse demand, while $\beta(s)$ affects its slope.

Using Eq. (4), we readily see that the demand for variety $s$ may be written as follows:

$$q(s) = \frac{\alpha(s) - \beta(s)}{\beta(s)} \cdot \frac{y(A - B)}{\beta(s)(1 + \gamma B)}$$

where

$$N \equiv \int_s \frac{ds}{\beta(s)} \quad A \equiv \int \frac{\alpha(s)}{\beta(s)} ds \quad P \equiv \int \frac{p(s)}{\beta(s)} ds.$$  

(6)

Thus, like in most models of monopolistic competition, the individual demand for a variety (Eq. (5)) depends on a few market aggregates, here $N, A$ and $P$. Using the spatial interpretation of $p(s)$ given above, it is straightforward that a group of varieties $r$, characterized by small (large) values of $\beta(r)$, have a strong (weak) impact on the demand for variety $s$ because consumers are (not) willing to buy much of them, as they (dis)like its horizontal characteristics better than those of $r$. This explains why $\beta(s)$ appears in the denominator of the aggregates $N, A$ and $P$.

Each variety is weighted by the inverse of its taste mismatch $\beta(s)$ to determine the effective mass of varieties, given by $N$. It is $N$ and not the unweighted mass of varieties $N$, which affects the consumers’ demand for a given variety. Indeed, adding or deleting varieties with bad taste matches does not affect much the demand for the others, whereas the opposite holds when the match is good. Note also that the effective mass of varieties $N$ may be larger or smaller than the unweighted mass of varieties $N$ in the product market, according to the distribution
of taste mismatches. Similarly, the quality and price of a variety are weighted by the inverse of its taste mismatch to determine the effective quality index $A$ and the effective price index $P$. In particular, varieties displaying the same quality (or price) may have a very different impact on the demand for other varieties according to their taste mismatches. The aggregate indices in Eq. (6) show that taste heterogeneity across varieties affects demand and, therefore, the market outcome. This shows that preferences (Eq. (2)) are asymmetric and capture several of the main features of the Lancasterian approach to product differentiation, such as different degrees of substitution between varieties, when varieties are asymmetrically located in the product characteristics space.

Note, finally, that Eq. (5) implies that the total mass of varieties consumed is given by

$$Q = \frac{A-P}{1+\gamma A}$$

which shows once more how the utility of a variety depends on the distribution of the taste parameter $\beta(s)$ since all the aggregate indices enter into $Q$. Incidentally, note that the definition of $Q$ corresponds to the second term in the right-hand side of Eq. (5), where it is weighted by the ratio $\gamma(\beta(s))$. Thus, the larger $Q$, the tougher the competition that each variety faces and the smaller its demand. For example, competition effects are stronger whenever the aggregate quality $A$ is higher. As a result, if the aggregate quality goes up this will reduce the demand for each variety. This may lower the WTP for a particular variety by so much that the choke price of this variety falls below its costs, thus driving this variety out of business. This channel of firm–product exit was hitherto missing in models where the level of quality was not included in the competition effects and, therefore, could not affect the exit (or entry) of products.

The above discussion shows that it is possible to introduce asymmetry across varieties in demand in a very simple way. As will be seen, preferences (Eq. (2)) also generate a large array of new effects. The demand for a variety $s$ now depends on its own horizontal and vertical attributes as well as on the effective mass of competing varieties $|N|$, the aggregate effective quality $A$ and the effective price index $P$. The interplay between these aggregate indices determines how a particular variety meets the competition.

Standard definitions of horizontal and vertical differentiations exist for indivisible varieties and with consumers making mutually exclusive choices. But these concepts until now were largely absent in models guiding the majority of empirical works in trade. Therefore, we consider the verti-zontal preferences particularly useful for those researchers who are interested in measuring and distinguishing horizontal (taste) from vertical (quality) attributes in trade. In contrast, in the standard quadratic utility, the common $\beta$-assigned to all the varieties affects both price and quantity sold of each variety, which makes it difficult to interpret it as a true parameter of horizontal differentiation. With the new and richer set of preferences introduced here, that distinction can now be made more clearly.

### 2.4. Heterogeneous consumers

Thus far, we have considered a set $I$ of homogeneous consumers. But now we relax this assumption and allow consumers to be heterogeneous. In terms of our beer example, allowing for heterogeneous consumers amounts to assuming that a representative consumer in one country may prefer Budweiser to Heineken, whereas a consumer in another country may prefer Heineken to Budweiser.

Formally this means that we allow the $\beta$-distribution to vary with $i \in I$. Thus, from this point forward, the taste-mismatch associated with a variety is consumer-specific. This implies that $i$ must now enter the taste mismatch parameter $\beta(s,i)$ to reflect the heterogeneity of consumers. Thus, taste mismatch is two-dimensional: it varies across varieties $s \in S$ as well as across consumers $i \in I$. That $\beta(s,i)$ varies with $s$ means that the same consumer $i$ has different attitudes toward different varieties (preferences are asymmetric), whereas $\beta(s,i)$ varies with $i$ because different consumers have different attitudes toward the same variety $s$ (consumers are heterogeneous).

Our main focus being on international trade, we follow most of this literature and assume that aggregate demands stemming from one country are derived from the maximization of a representative consumer’s utility, such as Eq. (2). As a consequence, in this paper there is consumer heterogeneity between countries but not within countries. Although aggregating consumer preferences within a country is a priori doable, we do not address this issue here for data reasons. Indeed, if the distribution of $\beta(s,i)$ with respect to $i$ were known, we could aggregate individual demands across consumers living in the same country and capture consumer heterogeneity within countries. This is exactly what is accomplished in the discrete choice literature where demand shocks are idiosyncratic to individual consumers, while aggregating demands across individuals yields the market demand when the distribution of shocks is extreme value.

We propose an alternative approach, which is more in line with the standard trade literature. In addition, our model allows for a simple description of consumers buying a variable number of units of each variety, something which is not easy to perform with discrete choice models. Note also that using discrete choice models when preferences across varieties are asymmetric is not an easy task. Most of the existing theoretical literature developed in industrial organization uses the multinomial logit, which assumes symmetry. Using the probit with different covariances turns out to be especially cumbersome, whereas our approach leads to simple and intuitive results. We see this as a strong comparative advantage of the verti-zontal model.

Our model can be used at different levels of demand aggregation, i.e. a household, a city, or a country. This makes it a potentially useful tool to address alternative issues, especially when data are available at a very disaggregated level such as barcode data within cities (Handbury and Weinstein, 2013). In what follows, we interpret a consumer as a country’s representative consumer. To be precise, we consider $I = \{1, \ldots, n\}$ as the set of destination countries and $S$ as the set of varieties available in country $i$. In such a context, our approach offers new insights into competition effects. Based on the standard quadratic utility given in Eq. (1), country size determines the number of varieties and, therefore, the competition effects. Allowing for consumer heterogeneity and asymmetric preferences across countries, as we do here, adds another dimension of competitiveness, taste mismatch and quality. In Melitz and Ottaviano’s (2008) type of models, two countries of similar size and GDP would have identical competition effects. Under the system of preferences we present here, this will not be the case, i.e., it will also depend on the quality of the varieties on offer and on their interaction with local preferences. Even with the same market size, the same number of firms, and the same quality on offer, this could still result in different competition effects because in one country one set of varieties match better local taste than in the others.

Because $i$ is now an index that varies from 1 to $n$ destination markets, we will replace $\beta(s,i)$ with $\beta(s)$. Prices and quantities will similarly be denoted $p(s)$ and $q(s)$, whereas the market aggregates $N_i, A_i$ and $P_i$ are indexed by $i$ only. This notation is also more convenient in the empirical analysis undertaken in Section 4.

### 3. Firm optimization and market outcome

Because the vertical and horizontal attributes and the marginal cost $c(s)$ vary across varieties, firms are heterogeneous along these three dimensions. Firms can be thought of as exporters of a particular country

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9 Using Hotelling’s spatial metaphor developed in Appendix A, the distance $(1/2)$ between shop 1 and consumer $i$ is ideal differs from the distance $(1/2)$ to consumer $j$’s ideal.

10 Since our model deals with heterogeneity at a firm-product level, firms can be either single product or multi-product. As in Bernard et al. (2011), we assume that each firm-product has a different marginal cost that is constant. We leave more complex multi-product issues, such as cannibalization and core competencies studied respectively in Eckel and Neary (2010) and Mayer et al. (2012), for future research.
of origin shipping products to destination countries indexed by $i$. Our analysis holds true when trade costs are incorporated. Indeed, it is sufficient to replace $c(s)$ with $c(s) + t_i$, where $t_i$ is the cost of shipping one unit of variety $s$ to country $i$. But we refrain from including trade costs everywhere for the sake of clarity of exposition. Empirically, trade costs will be captured by product-destination specific dummies, which amounts to assuming that trade costs are the same for all varieties of a given product exported from the same country of origin to the same destination, which seems plausible.

3.1. Profit maximization

The operating profits earned from selling variety $s$ in country $i$ can be written as follows:

$$\Pi_i(s) = [p_i(s) - c(s)]q_i(s).$$

Note that in our model markets are segmented, so that $q_i(s)$ and $p_i(s)$ differ according to the destination country the firm exports its variety to.

Let $S_i$ be the set of varieties available in country $i$. The benefits of using quasi-linear preferences are reaped here since firms' profits affect only the consumption of the numéraire regardless of their level and the way profits are determined. As a consequence, the analysis of the equilibrium provided below is robust against different modeling entry strategies.

Because the variety $s$ is negligible to the market, differentiating $\Pi_i(s)$ with respect to $p_i(s)$ yields:

$$p_i^\prime(s, p_i) = \frac{\alpha(s) + c(s)}{2} - \frac{\gamma(\alpha_i - p_i)}{2(1 + \gamma N_i)}$$  \hspace{1cm} (8)

The natural interpretation of Eq. (8) is that it represents firms’ best-reply to the market conditions in country $i$. These conditions are defined by the aggregate behavior of all producers, which is summarized here by the price index $p_i$. The best-reply function is upward sloping because varieties are substitutes: a rise in the effective price index $p_i$ relaxes price competition and enables each firm to sell its variety at a higher price. By shifting the best reply downward, a larger effective mass $N_i$ of firms makes competition tougher and reduces prices.

In contrast, since we do not deal with firms’ quality choice, $\alpha_i$ is exogenously determined by the distributions of quality ($\alpha_i(s)$) and tastes ($\lambda_i(s)$) over $S_i$. In particular, when the quality index $\alpha_i$ rises, each firm faces competing varieties which together represent a higher aggregate quality, thus making the market penetration of a particular variety harder. Note also that $\alpha_i$ affects prices positively, even though it affects each individual variety’s price negatively. This implies that an increase in aggregate quality in a country raises price levels, but makes it harder for an individual variety to survive. Thus, through market aggregates, we manage to reconcile weak interactions under monopolistic competition with several of the main features of Hotelling-like models of product differentiation.

Integrating Eq. (8) over $S_i$ shows that the equilibrium price index can be expressed in terms of the aggregate indices $\alpha_i$, $\gamma i$, and $N_i$:

$$\beta_i = \gamma_i + \frac{\alpha_i - C_i}{2 + \gamma N_i}$$  \hspace{1cm} (9)

where the cost index $C_i$ is defined as follows:

$$C_i = \int S_i \frac{c(s)}{p_i(s)} \, ds.$$

Hence, as in the other market indices, varieties’ costs are weighted by the taste distribution in the country of destination. The interpretation is that efficiently produced varieties may have a low impact on the cost index when they have a bad match with local taste. In sum, each destination country is characterized by a different set of market aggregates ($N_i$, $\alpha_i$, $C_i$, and $\beta_i$), which are all weighted by the destination-specific taste distribution.

2. Market equilibrium

The market process is described by an aggregative game involving a continuum of players (the variety suppliers) and a single market aggregate $p_i$, per destination country. The equilibrium outcome is given by a Nash equilibrium, which is determined as follows. Plugging Eq. (9) into Eq. (8), we obtain the equilibrium price of variety $s$ in country $i$:

$$p_i^\prime(s) = \frac{\alpha(s) + c(s)}{2} - \frac{\gamma(\alpha_i - p_i)}{2}$$  \hspace{1cm} (10)

where $\alpha_i$ is the average effective quality in country $i$ of varieties present in this country and $\gamma_i$ is the average effective marginal production cost of the varieties present in country $i$; be they domestically produced or imported:

$$\alpha_i \equiv \frac{\alpha_i}{N_i}, \quad \gamma_i \equiv \frac{\gamma N_i}{1 + \gamma N_i}$$

while

$$\gamma = \frac{\gamma N_i}{2 + \gamma N_i} \in [0, 1].$$

Clearly, the equilibrium price of a single variety depends on the market aggregates $\alpha_i$, $C_i$, and $N_i$, which in turn depend on the whole distribution of the taste mismatch parameter $\beta_i$ as well as on the cost ($\alpha_i$) and quality ($\alpha_i$) parameters of the competitors in country $i$.

As for the parameter $\gamma_i$, it reflects the toughness of competition in country $i$, which can make the equilibrium price range from perfect competition to pure monopoly. This is an important additional feature of the preferences presented in this paper: it offers the possibility of studying different types of market structure in trade models by varying the toughness of competition. To see this, consider the following example. When $\gamma N_i$ is arbitrarily small, which means that variety $s$ has only poor substitutes in country $i$, each variety is supplied at its monopoly price because $T_i \to 0$. On the other hand, when $T_i \to 1$, country $i$ is crowded by many good substitutes, which means that the market outcome converges toward perfect competition.

The benefits of assuming that $\gamma$ is the same between any pair of varieties are reaped by capturing the intensity of competition within a particular product and country through $T_i$. In addition, the toughness of competition may vary from one country to another because $T_i$ depends on the effective mass of competing varieties in each country, which depends itself on the country-specific taste distribution.\footnote{This parameter can be nicely related to the existence of different price ranges across sectors observed by Khandelwal (2010). Noting that each variety is characterized by an idiosyncratic quality and cost parameter, we can show that, paraphrasing Khandelwal, it is the length of the markup ladder that varies across sectors in our model: the tougher the competition, the shorter the ladder.}

It follows from Eq. (10) that higher quality results in higher prices, but the opposite need not hold. Prices can rise for other reasons such as higher costs or lower competition. This points at the need to complement unit values with cost controls to properly measure quality at the variety level, which is not always possible without access to additional firm-level information.

Note also that the first term of Eq. (10) is variety-specific (the parameters are all indexed $s$). These variety-specific determinants of prices and per-capita quantities, such as cost and quality, do not vary by destination country and influence prices and quantities in a similar way in all countries. However, the second term in Eq. (10) is not variety-specific but depends on destination market aggregates that are identical for all the varieties (beer) sold in a particular country $i$.
these indices are country-specific variables (all indexed i) we refer to the second term in Eq. (10) as a market effect.

The (absolute) markup is given by

\[ p_i^s(s) - c(s) = \frac{\alpha_i(s) - c(s)}{2} - \frac{\gamma_i - \tau_i}{2}. \]  

As expected, the markup increases (decreases) with \( \alpha_i(s) \) (\( c(s) \)). More importantly, it also increases (decreases) with \( \tau_i \). Hence, when varieties available in country \( i \) have a high quality (a low cost) and a good match with country \( i \)'s consumer tastes, the price at which variety \( s \) can be sold in country \( i \) is low. By contrast, when the same varieties have a bad match, variety \( s \) can be sold at a high price. Therefore, quality as such is not enough for a variety to be successful in a specific country.

In addition to low productivity, low quality and competition effects, exports of a variety may be zero because of its high taste mismatch in the destination country. A zero trade flow may thus stem from any of these aforementioned reasons, or combination of them, thus rendering the identification of individual parameters problematic. This differs from standard models in which productivity is the main parameter to explain entry into export markets (Helpman et al., 2008).

The market effect implies that fob prices can differ depending on destination countries through the \( f \) indexed market aggregates. However, \( r_i(s) \) does not enter the price Eq. (10) directly, whereas it does enter directly in the equilibrium quantity Eq. (12). This is important for several reasons. First, it offers an opportunity for the identification of parameters \( \alpha_i(s) \) and \( \beta_i(s) \) based on the fact that taste affects directly quantities but not prices. Second, it confirms the interpretation of the parameter \( \beta_i(s) \) as capturing horizontal differentiation. Also, whereas the price Eq. (10) is a linear and separable equation, the quantity Eq. (12) is not. The reason is that \( \beta_i(s) \) is both country- and variety-specific.

Note that the equilibrium price of variety \( s \) is independent of \( \beta_i(s) \) because the price elasticity is independent of this parameter:

\[ \epsilon_i(s) = -\frac{p_i(s)}{\alpha_i(s) - c(s)} = \frac{r_i(s)}{\alpha_i(s) - c(s)}. \]

Since \( \beta_i(s) \) does not affect \( \epsilon_i(s) \), it has no impact on \( p_i(s) \). However, the whole \( \beta \)-distribution matters for the elasticity because it influences the equilibrium value of \( q_i \), as shown by Eq. (7). This shows once more how the variables of the model can be affected differently by the taste mismatch parameter.

We summarize those results as follows.

**Proposition 1.** Equilibrium export prices depend on variety-specific cost and quality as well as on the market-specific degree of competitiveness. Market effects, which can be captured by taste-weighted market aggregates and quality and cost indices as well as by the effective mass of competitors, vary with the destination country, but are common to all varieties exported there. Thus, export prices of the same variety across countries only vary through market-specific effects.

**Proposition 2.** Equilibrium export quantities (sales) depend on market-specific and variety-specific tastes. Thus, export quantities of the same variety across countries show additional variability, as compared to prices, because of idiosyncratic tastes.

Based on the these propositions, we would expect the combination of variety characteristics and country characteristics to be important and to give a high goodness-of-fit for prices, but a much lower goodness-of-fit for quantities (sales). This is what we will explore in the next section.

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12 The parameter \( \beta \) does not enter prices because firms in their profit maximization trade-off setting a higher price when taste is strong and having smaller sales, to setting a price independent of taste but getting a large market share.
3. Parameter identification

An interesting feature of our model is that its parameters are identifiable. The model's particular functional form allows researchers to directly measure quality differences between varieties in the same destination country and to estimate the taste mismatch parameter at the country–variety level. The parameter capturing country–variety-specific taste mismatch, i.e. horizontal differentiation is the most easily identifiable. To determine its value, we rewrite Eq. (13) and show it is the ratio between each variety’s markups and its quantities sold, at any given point in time:\footnote{Note that our approach would be consistent with the assumption of both linear or iceberg transport costs, as long as they are product-specific and do not vary by variety.}

$$\beta_{f_t}(s) = \frac{p_{f_t}(s) - c_t(s)}{q_{f_t}(s)}.$$\footnote{Note that our approach would be consistent with the assumption of both linear or iceberg transport costs, as long as they are product-specific and do not vary by variety.}

However, empirical identification of the “taste mismatch” parameter would require firm–product level information on costs or markups. But this data is not available to us, and will not be pursued here. Instead, in Section 4 we use cross-sectional exporter data on prices and volumes of variety-level shipments, to determine the plausibility of the verti-zontal model in first instance.

As for the parameter capturing variety-specific vertical differentiation, it can be measured in relative terms. Note that $\alpha(s)$ is the value in terms of numéraire attributed by consumers to the vertical characteristics of a particular variety $s$. In relative terms, quality differentials between any couple of varieties (say, $r$ and $s$) can be readily obtained by exploiting the property that relative prices of different varieties in a common destination country depend only upon differences in costs and quality since both face the same market effects and thus they drop out when looking at relative quality (as shown in Eq. (10)):

$$\Delta \alpha_t(s,r) = \alpha_t(s) - \alpha_t(r) = 2 \left[ p_{f_t}(s) - p_{f_t}(r) \right] \left[ c_t(s) - c_t(r) \right].$$

Measuring the distance between the quality of all the varieties, $\alpha(s)$, and the quality of the lowest-quality variety, $\alpha(0)$, one could identify the relative quality distribution of the varieties present in country $i$ at time $t$ and eventually normalize it to have an idea of the relative distribution of varieties’ quality in a country. This means that no additional information or indirect estimation methodology would be needed to capture the relative quality of each variety in a country.

Empirical identification of relative quality in Eq. (15) would also require detailed information on firm–product costs, which is not available to us. Instead the main question we aim to address here is whether the determinants of export prices and quantities across destinations are now allowed to differ between the various firm–product combinations available in the country. In what follows we define a variety as a firm–product combination. We consider each product (typically CN8) as a separate product market within which we can meaningfully consider the determinants of export prices and quantities across destinations for varieties shipped from Belgium.

We use raw data on unit values and quantities and drop outliers at the 1% of the distribution. The only data restrictions that we impose are that, first, each firm faces some competition in their own CNB product in a particular destination country and, second, that a variety is exported to more than one country. In practice, we impose a minimum of two firms–CNB products to be present in the same destination and a minimum of two export markets for each variety. In this way, we can identify a variety- and a destination-specific effect in the regressions. While results are not very sensitive to an increase in the number of competing varieties per destination country, with each additional variety that we require to be present in a country, the number of observations for the regression falls substantially. Table 1 shows how the restricted sample compares to the full sample for both weights and units.

4. Evidence on taste heterogeneity across countries

4.1. Data

We use data on firm–product–country trade flows of Belgian exporters. The data is composed of fob (free on board) export prices and quantities by destination country. This allows us to compare prices (unit values) and quantities of the same varieties across destinations as well as prices and quantities of different varieties within the same destination. The Belgian export data are obtained from the National Bank of Belgium’s Trade Database and are a cross-section of the entire population of recorded annualized trade flows at the firm level by product and destination. Exactly which trade flows are recorded (i.e., whether firms are required to report their trade transactions) depends on their value and destination. For extra-EU trade (trade partner outside the EU borders), all transactions with a minimum value of 1000 euros or weight of more than 1000 kg have to be reported. For intra-EU trade, (trade partner inside the EU borders), firms are only required to report their export flows if their total annual intra-EU export value is higher than 250,000 euros. The products are recorded at 8-digit Combined Nomenclature (CN8).\footnote{The CN classification is equal to the HS classification at the 6 digit levels.} In most cases, CN8 output is measured in weight (kilograms), but for a smaller set of products, quantities are also expressed in units (liters, bottles, pairs etc.).\footnote{Measurement error that can plague quantity measurement should be lower when output is measured in units be it that the number of observations is much lower. For this purpose we report results both for units and weights.}

Due to its hierarchical nature, CN8 products can also be classified as products at more aggregate levels. For firms with primary activity in manufacturing, the data includes more than 5000 exporters and over 7000 different CN8 products, exported to 220 countries, for a total of more than 200,000 observations. We use cross-sectional export data for the year 2005 from manufacturing firms for which both values and quantities exported are reported. We do not have information on other firm-characteristics.

With the data at hand we can combine a product category at 8-digit level (CN8), say beer, with a firm-identifier such that beers can be distinguished from one another by the firm they are exported by. These firm–product combinations are allowed to enter consumer preferences differently. Even with the very detailed product classifications that we have in our data, one limitation is that it cannot be excluded that there may still be heterogeneity within the 8-digit product category that cannot be observed (e.g., specific brands, distribution channels, and so on). While most 8-digit products have a precise description, for some products this is less the case. But what is important to keep in mind is that, by linking the product to a firm, consumer preferences are now allowed to differ between the various firm–product combinations available in the country. In what follows we define a variety as a firm–product combination. We consider each product (typically CN8) as a separate product market within which we can meaningfully consider the determinants of export prices and quantities across destinations for varieties shipped from Belgium.

We use raw data on unit values and quantities and drop outliers at the 1% of the distribution. The only data restrictions that we impose are that, first, each firm faces some competition in their own CNB product in a particular destination country and, second, that a variety is exported to more than one country. In practice, we impose a minimum of two firms–CNB products to be present in the same destination and a minimum of two export markets for each variety. In this way, we can identify a variety- and a destination-specific effect in the regressions. While results are not very sensitive to an increase in the number of competing varieties per destination country, with each additional variety that we require to be present in a country, the number of observations for the regression falls substantially. Table 1 shows how the restricted sample compares to the full sample for both weights and units.
effects, and local competition effects in the destination can be captured by country–product fixed effects.

The following empirical specification where we regress individual firm–product prices \( (y_{it} = p_{it}) \) and quantities \( (y_{it} = q_{it}) \) on variety and destination dummies allows for an easy way to discriminate between the verti-zontal and the other models:

\[
y_{it} = \delta_0 + \delta_i \text{Firm}_{Product_i} + \delta_c \text{Country}_{Product_i} + \epsilon_{it}
\]

In the regressions we use alternatively price \( (p_{it}) \) and quantity \( (q_{it}) \) level data as dependent variables. Every variety \( s \) in (16) belongs to the same product-market \( S \), which corresponds to a CN8 product category. The equilibrium price Eq. (10) implies that firm–product quality and cost affect prices in a similar and linear way. So, even without identifying quality and without disentangling quality and cost, a simple OLS regression of export prices on firm–product dummys is expected to capture this variation and to explain an important part of the price data. Since cost and quality are variety-specific, firm–product dummies should account for that.

According to the verti-zontal model, the other determinants of export prices are all country effects indexed by \( j \) in Eq. (10). These country effects affect all varieties (firm–CN8) competing in the same country–product in the same way and also enter the price equation in a linear way. Since our trade data holds information on destinations, we can approximate country effects through country–product dummies. Based on the theory, the joint inclusion of firm–product and country–product dummies is expected to yield a good fit in a regression on individual firm–product prices.

In the verti-zontal model, the same set of variables is expected to perform less well in explaining variation of quantities across countries. In addition to quality, taste differences between consumers also matter. This is expected to result in a very different fit between price and quantity regressions where we expect quantities to have a consistently lower \( R^2 \).

The reason is that quantities are not just a function of firm–product cost and quality and country-level competition effects, but are also determined by idiosyncratic taste \( \beta_{is} \) that makes the quantity Eq. (12) a non-linear one.

We do not log-linearize prices and quantities in Eq. (16), as for example Bastos and Silva (2010) or Hallak and Sivadasan (2013) do. That is because in our case, by using the raw data for unit values and output, we impose a stricter test of the model since linearity of demand is one of the specific implications of our model and it is what distinguishes the price from the quantity regressions in Eq. (16). Furthermore, taking logs would have been useful if we had been interested in interpreting the specific regression coefficients, but this is not what we are after. Instead we focus on the value of the \( R^2 \) as a measure of the goodness-of-fit in the regressions.

As we will show in the regressions, the systematically lower \( R^2 \) for quantities than for prices in almost every product, industry and destination that we consider, is suggestive that quantities do not depend on the same fundamentals as prices. Based on our theory, we consider taste heterogeneity to be the underlying reason.

Unfortunately, a formal test on the significance of differences in \( R^2 \) does not exist. Therefore, complementary to a goodness-of-fit test, we also present a correlation test (Section 4.2). Propositions 1 and 2 can also be formulated in terms of price and quantity correlations across countries. The advantage of using correlations is that a formal test statistic exist which allows us to formulate and test the prediction of weaker quantity correlation across countries. While the evidence is overwhelmingly in favor of our model, we refrain from considering it as conclusive that “taste” is the only missing source of variation.

4.3. Predictions from verti-zontal versus other models

What do we expect to be the goodness-of-fit of an empirical approximation of both the price and quantity Eq. (16) estimated on cross-sectional data? And how do the predictions under verti-zontal preferences differ from other models?

Let us start by considering the case of a standard CES model where productivity is the only source of heterogeneity, as in Melitz (2003). In such a model, prices are expected to differ between varieties but not for the same variety across countries. Under a standard CES, fob export prices are the same independently of the destination to which the product is shipped. Therefore, we would expect a variety-fixed effect, which accounts for cost heterogeneity between firms, to account for all the variation in prices. This also applies to a CES model with consumer taste draws, as in Bernard et al. (2011).

A CES model with taste draws by variety–country and a discrete choice model with a different taste distribution per destination country are closest to the verti-zontal model in rationalizing the stronger quantity variability that we and others find in the data. However, they cannot explain the joint variability of prices and quantities described below. A CES model with taste draws would predict that export prices do not vary by destination country, while our data clearly shows they do. In a discrete choice model, a stronger taste for a product would also result in a higher price for that product, which would result in strong price volatility and would render the goodness-of-fit of Eq. (16) for prices as low as for quantities, which is not what we observe in the data.

Thus, based on a standard CES model (with or without taste draws), we would not expect additional variability in fob prices to come from country-fixed effects or, alternatively, from more narrowly defined country–product fixed effects.

For quantities, a standard CES model assigns a role to country effects, driven by income differences across countries. Country fixed effects would also explain some of the variation in quantities. Thus, in a CES model we would expect country dummies to raise the goodness-of-fit in the quantity regressions, but not in the price regression. In other words, a CES model would predict a higher goodness-of-fit for quantities, but this is not what we observe in the data.

In a CES model augmented with quality, as in Baldwin and Harrigan (2011), the variety-fixed effect would now account for both productivity and quality differences between firm–products. While the use of variety-RE does not allow us to separate cost from quality heterogeneity, it does allow us to distinguish the type of quality differentiation that firms are making. If firms ship the same quality to all destination countries, then the variety-fixed effect would take up all the variation in prices. In such a world, adding country-fixed effects to the regression would yield no additional explanatory power for prices, while it would for quantities, as in the standard CES. But should firms ship a different quality of the same variety to different countries, this would correspond to a parallel demand shifter that varies by country. In such a model, we would expect this quality variation to be absorbed by country-fixed effects both for prices and quantities. Country-fixed effects in the quality regression would additionally also absorb income differences between countries.

Thus, based on a CES model, irrespective of whether quality is intrinsic to a variety or depends on the destination country, we would not expect a lower goodness-of-fit of Eq. (16) in the quantity regression compared to the price regression. Thus, the prediction from a CES model is quite different from Proposition 1 derived from the verti-zontal model.

What about a standard quadratic utility, as in Melitz and Ottaviano (2008)? In such a model, both the equilibrium prices and quantities are a linear combination of a variety-specific effect and a country-effect. The variety effect captures heterogeneity in costs across firm-products, while a country-effect captures competition effects that vary by destination country. Based on a standard quadratic utility, price
and quantity variation should both be equally well explained by a combination of variety–(firm–product) fixed effects and country-fixed effects. Thus, in contrast to the verti-zontal model, a standard quadratic utility would predict both price and quantity dummy regressions on variety and country fixed effects to give an equally high goodness-of-fit measured by the $R^2$.

A quadratic utility model augmented with quality would give a similar prediction as a standard quadratic utility model. Quality acts as a parallel demand shifter between varieties and possibly even within varieties across countries. But this should not alter the equality in goodness-of-fit between a price and a quantity dummy regression. Therefore, even in a quadratic utility model with quality differentiation, we would continue to expect an equally good fit for price and quantity regressions in dummy regressions on variety and country fixed effects.

Thus, the verti-zontal model is the only model that predicts a systematically lower $R^2$ in quantity regressions than in price regressions when variety and destination effects are accounted for.

Under verti-zontal preferences, equilibrium quantities are determined by a non-linear combination of variety– and country–variety-specific variables. This non-linearity in output is driven by the presence of variety–country specific idiosyncratic taste, which can be seen from Eq. (12). However, we continue to have a linear equilibrium price equation, where the taste parameter does not enter directly, leaving all the variability to be explained by variety characteristics and country characteristics. Therefore, to capture the variation in firm–product–country prices (unit values) with a linear combination of variety– and country fixed effects is expected to yield a high goodness-of-fit in the price equation. In contrast, trying to fit a linear model on a combination of variables that are expected to behave in a non-linear way, as in the case of firm–product–country quantities, is expected to yield a much lower goodness-of-fit. This result is not affected by selection issues because variety characteristics are intrinsic to each variety in every destination market while country characteristics affect all the varieties present in a particular country in a symmetric way. A simple test where we approximate firm–product variation and country–product variation through a set of dummies for each provides an easy and direct way of discriminating between all the models discussed above.

Before discussing the results of the specification Eq. (16), we first consider the within data variation explained by firm, product and country-level effects alone. The highly disaggregate nature of our trade data at the 8-digit CN level enables us to examine heterogeneity of within-firm, within firm–product and within country–product unit values and output across countries and to compare results to earlier findings in the literature.

4. Results

4.1. Heterogeneity across firms, products and countries

In our dataset, quantities are expressed in weight (kilograms) or alternatively in units (pairs, liters, and so on). The results for quantities expressed in units are less likely to be plagued by measurement error and as such we regard them as a robustness check. But we first discuss the results for products whose quantities are given in weights for which we have many more observations. The results on the two samples are shown in Table 2.

In column 1 we include firm-fixed effects (FE) to see how much data variation in prices and quantities is explained by firm heterogeneity. Including firm-FE is equivalent to assuming that there is only one source of heterogeneity in the data and it works at the firm level, for example when cost and quality differences are small between products of the same firm but are significant between products of different firms. The results in column (1) do not confirm this assumption. The inclusion of firm-FE alone explains about a third (38%) of the variation in prices. This finding is comparable to Munch and Nguyen (forthcoming) and others.18 But while previous studies looked at sales variation, we separate price from quantity variation. For quantities, firm-specific effects explain much less of the variation. Only 16% to 19% are explained depending on whether we measure output as “quantity per capita of the destination country” or “quantity per dollar of GDP of the destination country.” The variation that firm-FE explain of simple quantities is 17% and lies between the other two output measures.

What about product-FE? In other words, how much of the variation in firm–product–country prices is driven by the type of product. Product-FE (columns 2 to 5) in the weight regressions, explain about 30% of price variability, but this varies substantially with the level of detail at which we define a product. At the most disaggregate level (CN2-FE) of a product definition products explain 18% of price variation and about 4% of quantity variation. At the most detailed product definition (CN8-FE), products explain 40% of price variation and about 12–15% of quantity variation, depending on how we measure quantities.

Clearly, for a given product, export unit values exhibit substantial variation. But the remaining variability is large and either comes from different firm-level costs and quality or from different destination countries served by the firms selling the same product.

With country–product FE, the explained variability for quantities is substantially higher (columns 6 to 9). For weights (Table 2), at the most detailed product-level (country–CN8), 55% of export price variability and 32% to 48% of quantity variability are explained. The $R^2$ for price and quantities in general are closer together when country–product fixed effects are considered. This is not a surprise and is consistent with both the verti-zontal and CES models. In the verti-zontal model country–product dummies which capture destination country-effects affect both prices and quantities. But country–product effects, at least in part, also capture taste heterogeneity since taste varies across countries. Taste is inherently non-linear, therefore we expect the country-dummies, which are parallel shifters, to capture quantity variation only in part. This is especially true when we consider “quantities per dollar of GDP of the destination country” where we already divide the dependent variable output by a country-specific variable.

With firm–product FE as the sole regressors (columns 10 to 13), the variability explained is also high compared to firm-level FE. This supports the assumptions made earlier in Sections 2 and 3 that most variation in quality and unit cost was at firm–product level. This assumption allows making predictions independent of the single- or multi-product nature of firms. Empirically, however, that assumption needs to be verified. At the most detailed level (firm–CN8), the explained price variability of observations in weight is now about 67%, while for quantities, the explained variability with the inclusion of firm–product FE explains about 33%, depending on how quantities are measured. Thus, the inclusion of a firm–product FE explains much more variability in both the price and quantity regressions than either firm-FE or product-FE. This justifies a theoretical approach that allows demand to vary by firm–product rather than by firm or by product only.19

Turning to products whose quantities are expressed in units, in the bottom of Table 2 we notice that all FE explain more of the variation in the data, but it should be kept in mind that the number of observations and varieties in units are much lower, as shown in Table 1.

16 Munch and Nguyen (forthcoming) find that firm-specific effects explain 31% of unconditioned export sales variation of Danish firms. Eaton et al. (2011) France finds that variation of sales conditional upon entry explains 39% of variation. Lawless and Whelan (2008) for Irish firms find firm-specific effects to account for 41% of firm destination sales variation.
18 Munch and Nguyen (forthcoming) using Danish export data also point out that the firm-product dimension is important to explain data variation.
19 Munch and Nguyen (forthcoming) using Danish export data also point out that the firm-product dimension is important to explain data variation.
prices ("unit values per unit") all types of FE give a higher fit in the regressions with units than with weights. But more importantly, the difference in $R^2$ between the price and the quantity regression is consistently present with a lower $R^2$ in the quantity regressions. For observations in units, which are arguably less subject to measurement error than weights, the difference of goodness-of-fit between prices and quantity regressions is even larger.

Single-attribute models, like the ones in Table 2, leave a substantial amount of variability unexplained, as also pointed out by Hallak and Sivadasan (2013). However, unreported F-tests turn out to be

### Table 1
The full and restricted data sample of Belgian firm–product–country exports.

<table>
<thead>
<tr>
<th>Weight</th>
<th>Units</th>
</tr>
</thead>
<tbody>
<tr>
<td>Full sample</td>
<td>Restricted sample</td>
</tr>
<tr>
<td>Observations</td>
<td>239,127</td>
</tr>
<tr>
<td>Firms</td>
<td>5386</td>
</tr>
<tr>
<td>CN2 products</td>
<td>95</td>
</tr>
<tr>
<td>CN4 products</td>
<td>1159</td>
</tr>
<tr>
<td>CN6 products</td>
<td>4122</td>
</tr>
<tr>
<td>CN8 products</td>
<td>7051</td>
</tr>
<tr>
<td>Destinations</td>
<td>220</td>
</tr>
<tr>
<td>CN2–destination combinations</td>
<td>8283</td>
</tr>
<tr>
<td>CN4–destination combinations</td>
<td>38,924</td>
</tr>
<tr>
<td>CN6–destination combinations</td>
<td>78,997</td>
</tr>
<tr>
<td>CN8–destination combinations</td>
<td>107,681</td>
</tr>
<tr>
<td>Trade volume (bil. euros)</td>
<td>88.10</td>
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<td>Destinations per firm-CN8</td>
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<tr>
<td>Median</td>
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</tr>
<tr>
<td>Min</td>
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</tr>
<tr>
<td>Max</td>
<td>160</td>
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<tr>
<td>Firms per CN8–destination</td>
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<tr>
<td>Median</td>
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</tr>
<tr>
<td>Min</td>
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</tr>
<tr>
<td>Max</td>
<td>235</td>
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</table>

Notes: "We use raw data on unit values and quantities dropping outliers at the 1% of the distribution. To be able to identify a variety-specific and a market-specific effect in the regressions, in the restricted sample we impose a minimum number of two markets for each firm-CN8 product and a minimum of two firms for each country-CN8 market."

<table>
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<td>$y = p \cdot q$</td>
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### Table 2
Single-attribute models and goodness-of-fit for pooled observations in weight and units.

<table>
<thead>
<tr>
<th>(1)</th>
<th>(2)</th>
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<th>(5)</th>
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<td>$y = p \cdot q$</td>
<td>$y = p \cdot q$</td>
<td>$y = p \cdot q$</td>
</tr>
</tbody>
</table>

Notes: the results in this table are based on the restricted sample as described in Table 1. Quantities expressed in weight (kilograms) or units (liters, bottles, pairs etc.).
The results associated with the single-attribute models in Table 2 suggest that firm–product and country–product dummies in isolation are relevant regressors. The variance decomposition in Table 3 suggests that the combination of the two is necessary to explain the data variability. The results of combining variety and country dummies to explain price and quantity variation are shown more systematically and for different product-level definitions in Table 4. In this Table we show the results of regressions where we pool data over all product categories, essentially assuming a single market in which all goods compete and insert firm–product and country–product dummies. We progressively narrow the definition of a product-market starting with firm–CN2 and move towards firm–CN8.

Independent of the product-market definition, we see that the variability explained in the price regression is always higher than in the quantity regressions. In the weights regressions, the difference between price and quantity regressions’ $R^2$ is about 20% to 40%, while for the units’ regressions in the bottom panel the difference is closer to around 40%. In the units’ regressions, the variation in the quantity regression explained is typically less than half of what is explained by the same two sets of dummies in the price equation. It is worth noting that the finer the firm–product and country–product definition, the better the goodness-of-fit for both the price and quantity regressions. But this can be attributed to the fact that more dummies also imply less residual degrees of freedom in the regression which tends to raise the $R^2$.

Two important insights emerge from the combined-attribute models in Table 4. First, while price variability is pretty much pinned down by a combination of variety and country dummies, quantity variability is less so. This is in sharp contrast to models that predict that prices and quantities should be perfectly correlated as they are supposedly determined by the same sources of variability, as in the standard quadratic utility setting. In addition it is in contrast with models predicting that destination-specific characteristics are the only additional source of variability when moving from prices to quantity equations, such as the CES. But our data seem to suggest that different sources of variability are at work, being destination-variety specific and affecting quantities rather than prices. Second, the empirical results show that the linear functional form that we imposed in Eq. (16) gives a good fit for prices but a consistently lower fit for quantities. This is in line with what we expect since the verti-zontal theory suggests that a linear form applies to prices but not to quantities which are inherently non-linear.

### 4.4.2. Combining variety and country dummies

In the ANOVA Table 3, we consider a combined attribute model of firm–CN8 and country–CN8. The ANOVA decomposition should tell us if a combined model is justified. Since the inclusion of firm–CN8 FE involves a larger number of dummies (degrees of freedom) than in the case of country–CN8 dummies, we may wrongly conclude that firm–product FE explain more of the data variation. The ANOVA analysis takes this different number of dummies into account such that we get a better idea about the relative importance of each regressor.

The results in the top panel of Table 3 show the results for the price regressions and the bottom panel for the quantity regressions. We report the Mean Sum of Squares (MS), which is the outcome of dividing the Partial Sum of Squares of each regressor (not shown for brevity) by its degrees of freedom from the regressions. As such the MS gives the explanatory power of each regressor per degree of freedom. Measured this way, firm–CN8 FE and country–CN8 FE account for a relatively even part of the variation explained, be it that the relative importance of the regressors alternates between specifications. In the quantity regressions, the importance of variety- versus country-FE is about even, while in the price regressions, the country–FE appears to be more important per degree of freedom. We do not explore this further since the relative importance of variety- versus country-specific effects is beyond this paper’s objectives. More importantly, the ANOVA analysis confirms that the inclusion of both variety-effects and country-effects seem warranted when explaining price and quantity variation.

The results of Table 3 show that firm–product and country–product dummies are relevant regressors. The variance decomposition suggests that the combination of the two is necessary to explain the data variability. The results of combining variety and country dummies to explain price and quantity variation are shown more systematically and for different product-level definitions in Table 4. In this Table we show the results of regressions where we pool data over all product categories, essentially assuming a single market in which all goods compete and insert firm–product and country–product dummies. We progressively narrow the definition of a product-market starting with firm–CN2 and move towards firm–CN8.

Independent of the product-market definition, we see that the variability explained in the price regression is always higher than in the quantity regressions. In the weights regressions, the difference between price and quantity regressions’ $R^2$ is about 20% to 40%, while for the units’ regressions in the bottom panel the difference is closer to around 40%. In the units’ regressions, the variation in the quantity regression explained is typically less than half of what is explained by the same two sets of dummies in the price equation. It is worth noting that the finer the firm–product and country–product definition, the better the goodness-of-fit for both the price and quantity regressions. But this can be attributed to the fact that more dummies also imply less residual degrees of freedom in the regression which tends to raise the $R^2$.

Two important insights emerge from the combined-attribute models in Table 4. First, while price variability is pretty much pinned down by a combination of variety and country dummies, quantity variability is less so. This is in sharp contrast to models that predict that prices and quantities should be perfectly correlated as they are supposedly determined by the same sources of variability, as in the standard quadratic utility setting. In addition it is in contrast with models predicting that destination-specific characteristics are the only additional source of variability when moving from prices to quantity equations, such as the CES. But our data seem to suggest that different sources of variability are at work, being destination-variety specific and affecting quantities rather than prices. Second, the empirical results show that the linear functional form that we imposed in Eq. (16) gives a good fit for prices but a consistently lower fit for quantities. This is in line with what we expect since the verti-zontal theory suggests that a linear form applies to prices but not to quantities which are inherently non-linear.

### 4.4.3. Regressions by products and industries

Pooling all the data, as we did until now, is similar to considering the product market as one integrated market which may hide heterogeneity between industries. For this reason in Table 5 we report results for Eq. (16) based on product-level regressions. Based on the results thus far we can say that including both variety- and country-FE at the most detailed product (CN8)-level is the specification that works most against our results since the price and quantity regressions for this most detailed definition of a product market lie closest to each other. Therefore we will work with this specification to give the data most chance to overthrow our theory.

In Table 5, we first consider all firm–CN8 varieties belonging to the same CN2 and exported to the same country to be in competition with each other in every country they are exported to. Put differently, we start by considering CN2 as the relevant product market where all goods are substitute products. This results in about 90 different CN2 product markets for weights and about 45 different CN2 industries for units. For each of these industries we run separate regressions of price and output on variety and country–product FE.

Column 1 of Table 5 reports the weighted average $R^2$ across all CN2 industries which is 65% for prices and about 36% for simple quantities.

| Column 1 of Table 5 reports the weighted average $R^2$ across all CN2 industries which is 65% for prices and about 36% for simple quantities. | }
The results in this table are based on the restricted sample as described in Table 1, for quantities expressed in weight (kilograms) and units (liters, bottles, pairs etc.). The only additional restriction, per CN product, is that the number of regressors for each type of dummy is lower than the number of observations to ensure some variability in the sample. The simple quantities. We subsequently narrow the definition of a relevant product market from CN4, CN6 to CN8. Even in the most narrow product market definition, where we consider 1701 separate regressions for each of the CN8 industries considered (weights), we find the weighted average R² for prices to be 66% and for simple quantities to be 46%. Column (3) shows that in 77% of the 1701 regressions that we ran, the goodness-of-fit in the price regression is strictly higher than that of the simple quantity regressions. Results are qualitatively the same when considering varieties in units. Results do not differ much when we measure output in a different way, although R² tend to go up slightly when considering quantity per capita or quantity per dollar of GDP.

Regressions at product-level thus confirm our prediction that a linear model, like the one in Eq. (16), appears to have less predictive power in quantity regressions. While this holds for the large majority of products we consider, from column (3) in Table 5 it is clear that there are instances where there is not always a positive difference between price and quantity R². Our theory does not rule out the existence of products where taste differences are not very important or where business-to-business sales are more important than business-to-consumer. Put differently, in the case of intermediate products the cost-minimizing combination of inputs in production functions

Table 4
Goodness-of-fit of the verti-zontal model for weight and units.

<table>
<thead>
<tr>
<th></th>
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<td></td>
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<td>y = p, q</td>
<td>y = p, q</td>
<td>y = p, q</td>
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<tr>
<td>Firm–CN2 FE</td>
<td>Yes</td>
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<td>Yes</td>
<td>Yes</td>
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<tr>
<td>Firm–CN4 FE</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Firm–CN6 FE</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Firm–CN8 FE</td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Country–CN2 FE</td>
<td></td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Country–CN4 FE</td>
<td></td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Country–CN6 FE</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Country–CN8 FE</td>
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<table>
<thead>
<tr>
<th></th>
<th>Weight</th>
<th>Units</th>
<th>Weight</th>
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<th>Weight</th>
<th>Units</th>
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<tr>
<td>Price regression R²</td>
<td>55.7%</td>
<td>83.1%</td>
<td>70.9%</td>
<td>91.2%</td>
<td>76.9%</td>
<td>95.1%</td>
<td>79.1%</td>
<td>96.0%</td>
</tr>
<tr>
<td>Quantity regression R²</td>
<td>28.6%</td>
<td>31.3%</td>
<td>40.3%</td>
<td>39.7%</td>
<td>50.7%</td>
<td>48.9%</td>
<td>56.7%</td>
<td>54.8%</td>
</tr>
<tr>
<td>Q per capita regression R²</td>
<td>31.6%</td>
<td>36.7%</td>
<td>43.5%</td>
<td>46.6%</td>
<td>53.4%</td>
<td>54.6%</td>
<td>59.1%</td>
<td>58.5%</td>
</tr>
<tr>
<td>Q per unit of GDP regression R²</td>
<td>39.6%</td>
<td>44.5%</td>
<td>51.7%</td>
<td>52.5%</td>
<td>60.0%</td>
<td>62.9%</td>
<td>63.7%</td>
<td>64.7%</td>
</tr>
<tr>
<td>Number of observations</td>
<td>111,876</td>
<td>20,929</td>
<td>111,876</td>
<td>20,929</td>
<td>111,876</td>
<td>20,929</td>
<td>111,876</td>
<td>20,929</td>
</tr>
<tr>
<td>Number of dummies</td>
<td>12,462</td>
<td>2963</td>
<td>26,423</td>
<td>4865</td>
<td>41,498</td>
<td>8363</td>
<td>47,956</td>
<td>9252</td>
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</table>

Notes: The results in this table are based on the restricted sample as described in Table 1, for quantities expressed in weight (kilograms) and units (liters, bottles, pairs etc.).

Table 5
Product-level regressions and goodness-of-fit for weight and units.

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<th>(3)</th>
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<tr>
<td></td>
<td>Weight</td>
<td>Units</td>
<td>Weight</td>
</tr>
<tr>
<td>By CN2</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Price R²</td>
<td>65.3%</td>
<td>74.0%</td>
<td>-</td>
</tr>
<tr>
<td>Quantity R²</td>
<td>36.3%</td>
<td>36.0%</td>
<td>93.3%</td>
</tr>
<tr>
<td>Q per capita R²</td>
<td>37.5%</td>
<td>40.6%</td>
<td>87.6%</td>
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<tr>
<td>Q per unit of GDP R²</td>
<td>42.4%</td>
<td>44.7%</td>
<td>84.3%</td>
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<tr>
<td>By CN4</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Price R²</td>
<td>65.4%</td>
<td>69.5%</td>
<td>-</td>
</tr>
<tr>
<td>Quantity R²</td>
<td>39.4%</td>
<td>41.4%</td>
<td>83.2%</td>
</tr>
<tr>
<td>Q per capita R²</td>
<td>42.5%</td>
<td>45.8%</td>
<td>81.8%</td>
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<tr>
<td>Q per unit of GDP R²</td>
<td>46.2%</td>
<td>49.6%</td>
<td>78.5%</td>
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<tr>
<td>By CN6</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Price R²</td>
<td>65.7%</td>
<td>71.4%</td>
<td>-</td>
</tr>
<tr>
<td>Quantity R²</td>
<td>44.3%</td>
<td>47.7%</td>
<td>77.5%</td>
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<tr>
<td>Q per capita R²</td>
<td>48.7%</td>
<td>51.3%</td>
<td>75.2%</td>
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<tr>
<td>Q per unit of GDP R²</td>
<td>51.5%</td>
<td>55.2%</td>
<td>73.4%</td>
</tr>
<tr>
<td>By CN8</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Price R²</td>
<td>66.4%</td>
<td>71.4%</td>
<td>-</td>
</tr>
<tr>
<td>Quantity R²</td>
<td>46.5%</td>
<td>49.3%</td>
<td>77.2%</td>
</tr>
<tr>
<td>Q per capita R²</td>
<td>50.6%</td>
<td>53.2%</td>
<td>74.9%</td>
</tr>
<tr>
<td>Q per unit of GDP R²</td>
<td>53.1%</td>
<td>56.5%</td>
<td>72.6%</td>
</tr>
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</table>

Notes: The results in this table are based on the restricted sample as described in Table 1, for quantities expressed in weight (kilograms) and units (liters, bottles, pairs etc.). The only additional restriction, per CN product, is that the number of regressors for each type of dummy is lower than the number of observations to ensure some variability in the sample. The regressors included are firm–CN6 and country–CN FE, for the different CN product categories. For each CN product category, averages of all the CN products are weighted by their number of observations. Results on prices are reported in bold.

The corresponding numbers for the units’ regressions is an average R² of 74% for prices and around 37% for simple quantities regressions. Column 2 of Table 5 shows the percentage of times that the goodness-of-fit in the price regressions exceeds that of the quantity regressions, which is around 93% for weight and 82% for units’ regressions when considering simple quantities. We subsequently narrow the definition of a relevant product market from CN4, CN6 to CN8. Even in the narrow product market definition, where we consider 1701 separate regressions for each of the CN8 industries considered (weights), we find the weighted average R² for prices to be 66% and for simple quantities to be 46%. Column (3) shows that in 77% of the 1701 regressions that we ran, the goodness-of-fit in the price regression is strictly higher than that of the simple quantity regressions. Results are qualitatively the same when considering varieties in units. Results do not differ much when we measure output in a different way, although R² tend to go up slightly when considering quantity per capita or quantity per dollar of GDP.

Regressions at product-level thus confirm our prediction that a linear model, like the one in Eq. (16), appears to have less predictive power in quantity regressions. While this holds for the large majority of products we consider, from column (3) in Table 5 it is clear that there are instances where there is not always a positive difference between price and quantity R². Our theory does not rule out the existence of products where taste differences are not very important or where business-to-business sales are more important than business-to-consumer. Put differently, in the case of intermediate products the cost-minimizing combination of inputs in production functions

25 For each CN product category averages are weighted by the number of observations, but results are very similar for weighted and simple averages.

26 Similar R² in prices and quantities could point at the absence of taste heterogeneity. A higher R² in the quantity regression than in the price regressions corresponds with predictions of a quality augmented CES model with quality differences for the same product by destinations.
may differ from the utility-maximizing consumption bundle of consumers. Our model is more likely to explain price and quantity variation of final consumption goods than of intermediate goods.

To have a first indication for which industries taste differences seem to matter less, we report in Table 6 industry-level regressions, where we group the CN2 products by the sections to which they belong in the RAMON Eurostat classification.

For the fourteen so-obtained industries, the regressions for weights do not reject our model. The $R^2$ for prices is typically 20% to 30% higher than for quantities. Only for exports in units for “Minerals and Chemicals” the quantity regression shows a stronger goodness-of-fit.

### Table 6

<table>
<thead>
<tr>
<th>Industries (CN2 product codes)</th>
<th>Exports in weight</th>
<th>Exports in units</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(1)</td>
<td>(2)</td>
</tr>
<tr>
<td>Agriculture</td>
<td>81.5%</td>
<td>35.5%</td>
</tr>
<tr>
<td>CN2 codes 1 to 15</td>
<td>(–)</td>
<td>–</td>
</tr>
<tr>
<td>Food and beverages</td>
<td>78.9%</td>
<td>33.6%</td>
</tr>
<tr>
<td>CN2 codes 16 to 24</td>
<td>(2047)</td>
<td>–</td>
</tr>
<tr>
<td>Minerals and chemicals</td>
<td>76.8%</td>
<td>37.1%</td>
</tr>
<tr>
<td>CN2 codes 25 to 38</td>
<td>(2649)</td>
<td>–</td>
</tr>
<tr>
<td>Plastics and rubber</td>
<td>56.7%</td>
<td>34.3%</td>
</tr>
<tr>
<td>CN2 codes 39 and 40</td>
<td>(2700)</td>
<td>–</td>
</tr>
<tr>
<td>Leather, skins and wood</td>
<td>78.5%</td>
<td>42.3%</td>
</tr>
<tr>
<td>CN2 codes 41 to 46</td>
<td>(562)</td>
<td>–</td>
</tr>
<tr>
<td>Articles of paper</td>
<td>50.4%</td>
<td>37.5%</td>
</tr>
<tr>
<td>CN2 codes 47 to 49</td>
<td>(1257)</td>
<td>–</td>
</tr>
<tr>
<td>Textile articles</td>
<td>86.0%</td>
<td>38.5%</td>
</tr>
<tr>
<td>CN2 codes 50 to 63</td>
<td>(2679)</td>
<td>–</td>
</tr>
<tr>
<td>Footwear and accessories</td>
<td>73.3%</td>
<td>48.1%</td>
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<tr>
<td>CN2 codes 64 to 67</td>
<td>(97)</td>
<td>–</td>
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<tr>
<td>Construction materials</td>
<td>75.5%</td>
<td>45.9%</td>
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<tr>
<td>CN2 codes 68 to 70</td>
<td>(612)</td>
<td>–</td>
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<tr>
<td>Base metals and jewelry</td>
<td>75.5%</td>
<td>40.6%</td>
</tr>
<tr>
<td>CN2 codes 71 to 83</td>
<td>(2395)</td>
<td>–</td>
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<tr>
<td>Mechanical appliances</td>
<td>59.4%</td>
<td>29.0%</td>
</tr>
<tr>
<td>CN2 codes 84 and 85</td>
<td>(3369)</td>
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<tr>
<td>Transport equipment</td>
<td>75.8%</td>
<td>40.2%</td>
</tr>
<tr>
<td>CN2 codes 86 to 89</td>
<td>(492)</td>
<td>–</td>
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<tr>
<td>Precision instruments</td>
<td>62.7%</td>
<td>30.9%</td>
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<tr>
<td>CN2 codes 90 to 93</td>
<td>(498)</td>
<td>–</td>
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<tr>
<td>Furniture and toys</td>
<td>68.6%</td>
<td>27.1%</td>
</tr>
<tr>
<td>CN2 codes 94 to 96</td>
<td>(980)</td>
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</tbody>
</table>

Notes: The results in this table are based on the restricted sample as described in Table 1, for quantities expressed in weight (kilograms) and units (liters, bottles, pairs etc.). As regressors we include firm–CN8 and country–industry FE. The industry “Agriculture” has been dropped from the sample because it had only 4 observations and the same number of dummies.

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**Fig. 1.** Pairwise rank correlations for a sample of the 12 relevant export markets selected from across the globe. Notes: The countries considered are: France, Netherlands, Germany, US, Canada, Brasil, South Africa, Australia, Turkey, China, India, Japan. The square dots indicate pairwise price rank correlations for all the 66 country pair combinations, triangle dots indicate quantity rank correlations. The horizontal line segments represent averages: the solid red for the prices, the dashed blue for the quantities. For illustration purposes, country pairs have been sorted in decreasing quantity rank correlation order. The shaded area covers the three pairs EU countries: France–Netherlands; Germany–France; Germany–Netherlands.

**Fig. 2.** The spatial metaphor of verti-zontal preferences.
This may suggest that taste effects are not important in this industry or that “Minerals and Chemicals” is more of a business-to-business industry for which our model may not apply.

More detailed industry studies will likely reveal where taste heterogeneity is strong and where it is not or where other factors are at play. In any case, all the evidence presented above seems to suggest that in the large majority of products and industries, taste heterogeneity matters since that is today the only model which can explain consistently lower $R^2$ of specification (16) in quantity regressions than in price regressions.

4.5. Robustness: correlations and remote destinations

A legitimate concern is whether our results are not driven by the fact that the most important trading partners for Belgium are European, which may have a dampening effect on price differences. If the high goodness-of-fit in the price regressions is the result of arbitrage or lack of border controls, this could drive the results. Therefore, as a consistency check, we investigate whether this trade orientation towards European destinations may have affected our results.

We do so by looking at a set of heterogeneous and remote countries (Australia, Brazil, Canada, China, India, Japan, South Africa, Turkey, and US), together with the three main trading partners of Belgium (France, Netherlands and Germany). For these countries we consider pairwise bilateral correlations for each country-pair of Belgian export prices and quantities shipped. An advantage of using correlations is that differences can be statistically tested for. But for pairwise correlations to be meaningful, we exclude zero trade flows here and only consider those with positive bilateral exports. This results in a balanced panel of 87 varieties and 1044 observations.

These pairwise correlations all lie around 90%, which is the average of all the bilateral price rank correlations considered and is indicated by the solid line at the top of Fig. 1. Proposition 1, which predicts that the price rankings of varieties within destination countries will not be affected by country effects, is confirmed by the high price correlation we find. Therefore, we would expect stable price rankings amongst a set of varieties exported even when the destination countries are remote and heterogeneous compared to the country of origin.

In contrast, the bilateral quantity ranking correlations given by the triangle dots in Fig. 1, can be as low as 50% as indicated by the dashed horizontal line segment, which is what we expect on the basis of Proposition 2. The four most correlated country pairs in terms of quantity ranks correspond to the three EU member states considered (France, Netherlands and Germany) and Turkey, a candidate EU member country. Of all the countries included, the ones with the highest pairwise quantity rank correlations are the three European countries. This can clearly be seen from Fig. 1 where EU countries are circled. Fig. 1 thus suggests that taste differences are smallest in the three EU countries included, which seems quite plausible given their proximity. All the quantity correlations are lower than price correlations in a statistically significant way at a 1% confidence level.

The evidence in Fig. 1 casts further doubt on measurement error in quantities as an alternative explanation for our findings. Measurement error would result in random variability in quantities, but Fig. 1 clearly shows that quantity variation is lower in nearby countries. This makes an explanation like “taste” more plausible as a source of quantity variation than measurement error, although we cannot exclude the possibility that measurement error would increase with distance from Belgium which would raise the variance of quantities for far away countries. Provided measurement error is not driving results, Fig. 1 also suggests that taste and distance to destination may be highly correlated, which raises some doubts on the correct specification of many gravity models where distance typically features as the prominent explanation explaining bilateral trade flows but which may in part capture taste effects that run along similar dimensions. This is another reason why future research should be focusing on separating taste effects in trade from other potential explanations at work.

5. Conclusions

This paper departs from standard specifications of preferences used in trade models by enriching the demand side. We deviate from the assumption that all substitute varieties within the same country face the same demand, and instead we allow for two sources of heterogeneity. First, varieties sold in the same country are allowed to be vertically differentiated as well as to have a different match with local consumers’ tastes. Second, the same variety sold in different countries is allowed to face a different demand depending on the interactions between local tastes and competition effects. This leads to a new and tractable framework in which taste heterogeneity interacts with cost and quality heterogeneity. We call it a verti-zontal model to stress its vertical and horizontal attributes. Our model displays enough versatility to be applied to a wide range of new issues.

An important prediction arising from taste heterogeneity in consumer preferences is that firm–product–country exports can be idiosyncratic and display additional variability even after controlling for firm-product specific productivity and parallel demand shifts. Detailed firm–product–country data for Belgian exporting firms confirm this prediction, which the model rationalizes as the outcome of taste differences unrelated to destination market size or income differences. This missing source of variation cannot be rationalized by any type of preferences used in models based on productive efficiency nor by models that rely on efficiency and quality, but can be captured by the new preferences we propose here. When empirically controlling for country-level differences, we still find quantity variation, which the theory we put forward rationalizes as taste differences.

However, we do not claim that taste heterogeneity is the only possible explanation for the sales variation of firm–products across countries. For that we would have to distinguish consumer taste from other potential sources of quantity variability, such as variation in distribution networks (Arkolakis, 2010) or demand build-up over time (Foster et al., 2012). This requires the specification of new models focusing on alternative explanations as well as their comparison to pin down their respective merits. This may, however, prove difficult as such alternatives may be highly correlated with taste factors, which are less directly observable. For example, the absence of a distribution network for a given variety may stem from the mismatch between the variety and local tastes. All that we claim here is that asymmetric preferences and heterogeneous tastes across countries can rationalize the data as a potential source of quantity variation.

Future research can be directed towards the empirical identification of the demand parameters involved in the verti-zontal model such as the identification of the taste parameter, clearly distinguished from the quality parameter. This calls for an external validation similar to the approach of Crozet et al. (2012) who use an external classification of champagne to calibrate the productivity and quality parameters using CES preferences. The quality and taste parameters arising from the verti-zontal model would then become available for a much wider set of product markets, including those for which external quality and taste indicators do not exist. Also, the empirical identification of the demand parameters can then be used to strip price indices from quality and taste changes to get better estimates of GDP growth indicators as

27 The criteria for choosing these countries included a maximum distance from Belgium, including as many different continents as possible and conditioning on the fact that countries received the same set of varieties exported from Belgium.

28 The lower quantity correlations, which we find in this balanced sample, are in line with the goodness-of-fit results obtained on the unbalanced sample in the previous section. This confirms that selection issues are not driving our results.
currently also pursued by Feenstra and Romalis (2012) who use a different model.

Appendix A. The micro-foundations of taste mismatch

To show how β(s) can be interpreted as a taste mismatch between variety s and the consumer’s ideal, we use a spatial metaphor based on the Hotelling (1929) model that has been used extensively in the industrial organization and marketing literature. In this metaphor, consumers are located on a unit line segment with a shop located at each end. The consumer’s location on the line determines the distance she has to walk to the shop where she buys one unit of a good. The distance traveled corresponds to the consumer’s taste mismatch between her ideal variety, given by the consumer’s location and the variety on offer in the shop. In Fig. 2, we depict such a setting in which two varieties/shops, indexed s = 1, 2, are located at the endpoints 0 and 1. Normalizing the transport rate at 1, β1 ≡ β(1) is the distance between the consumer and shop 1. In other words, a high (low) value of β1 amounts to saying that the consumer is far from (close to) shop 1. The further the consumer is from the shop, the lower her utility from consuming the good, due to the disutility of traveling a long distance. Moreover, β2 ≡ β(2) = 1 − β1 > 0 is the distance between our consumer and shop 2. When preferences are symmetric, the consumer is located at β1 = β2 = 1/2.

We now show that this distance in the Hotelling spatial model corresponds with the parameter β(s) in the quadratic preferences. When preferences exhibit a love-for-variety as in Eq. (2), consumers may visit several shops and can buy several units (see Hart, 1985) of different varieties of a good. To facilitate the analogy between the Hotelling model and the quadratic preferences in Eq. (2), we make a simplifying assumption where we limit the number of goods in Eq. (2) to two and where we assume that α1 = α(s) = α. Under this assumption, the consumer’s willingness-to-pay (WTP) is equal to α.

This allows us to draw an analogy between Hotelling’s spatial model, where consumers are heterogeneous in one dimension, i.e. their location, and the preferences in Eq. (2) in which varieties can differ along several dimensions.

To explain this link we turn to Fig. 2 and consider to what the new preferences in Eq. (2) correspond to. Assume first that a particular consumer i on the line considers buying variety 1. Because β1 < 1 − β1, the consumer located at β1 is willing to buy variety 1 first if her distance to shop 1 is smaller than for α. For this to happen, the interval [1 − α] must be non-empty. In other words, the WTP for the differentiated good must be sufficiently large. When β1 < α, the consumer visits shop 1.

While Hotelling’s story stops here because consumers make mutually exclusive purchases, this is not the case in love-for-variety preferences. As long as α exceeds 1/2, there is a segment [1 − α] in which both α − β1 and α − (1 − β1) are positive for any β1 ∈ [1 − α, α]. Since consumers have a love for variety, consumer i wants to visit both shops if she is located in the segment [1 − α]. However, for this to happen, when turning to shop 2 we must account that the consumer has already acquired one unit of the good so that her WTP is now shifted downward by γ/2. Therefore, the segment over which both shops are actually visited is narrower than [1 − α, α] and given by [1 − α + γ/2, α − γ/2]. Consequently, when the consumer is located at β1 < 1 − α + γ/2 (β1 > α − γ/2), she visits shop 1 (2) only, whereas she chooses to visit both shops when her location belongs to [1 − α + γ/2, α − γ/2]. For this to be possible, however, this interval must be non-empty, that is, the condition

\[2α > 1 + γ\]

20 When α > 1/2, a consumer located in the central area does not shop at all because both her desirability of the differentiated good is low and her taste mismatch is high. In the standard Hotelling framework, this corresponds to the case in which the price of the good plus the transport cost borne by the consumer exceeds her reservation price.

must hold. This is so when the desirability of the differentiated good is high, the substitutability between the two varieties is low, or both. Conversely, it is readily verified that, regardless of her location, the consumer acquires a single variety if and only if γ > 2α − 1.

In other words, when varieties in Eq. (2) are very good substitutes, consumers choose to behave like in the Hotelling model: despite their love for variety, they visit a single shop because the utility derived from buying from the second shop is overcome by the cost of visiting this shop.

The foregoing argument shows how the spatial model can cope with consumers buying one or two varieties of the differentiated good and how consumers’ decisions to buy one or two varieties are related to the taste mismatch with each variety. While we develop the example for two varieties on offer, this can be extended to any number of varieties. In particular, when consumers’ ideal varieties are described by means of n-dimensional vectors with n > 1, it is readily verified that what we have said above can be extended by considering n + 1 varieties in Rd.

References

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