

CORE DISCUSSION PAPER
2005/96

**QUALITY IMPROVEMENT AND NETWORK
EXTERNALITIES**

Jean J. GABSZEWICZ¹ and Filomena GARCIA²

January 2006

Abstract

We analyse the optimal pricing choice of an incumbent firm that sells a good with network externalities and is threatened by the entry of a higher quality variant. In the framework of a vertical differentiation model, we find a necessary and sufficient condition under which quality improvement occurs as a result of this competition. **Keywords:** vertical product differentiation, network externalities, quality improvement.

JEL Classification: L11, L12, L15.

¹CORE, Université catholique de Louvain, Belgium.
E-mail: gabszewicz@core.ucl.ac.be

²CORE, Université catholique de Louvain, Belgium.

We thank Paolo Colla for his insightful comments on a previous version of this paper. We are grateful to Jacques Thisse and Xavier Wauthy for their helpful comments and suggestions. Filomena Garcia thanks the financial support of Fundacao Gulbenkian and CORE.

This paper presents research results of the Belgian Program on Interuniversity Poles of Attraction initiated by the Belgian State, Prime Minister's Office, Science Policy Programming. The scientific responsibility is assumed by the authors.