Price-Setting Behavior in the Presence of Social Interactions

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Summary

We consider a market with a profit-maximizing monopolistic firm. Utility-maximizing consumers either buy one unit of the good or none at all. The demand for the good is influenced by local social interactions. That is, the utility which a consumer derives from the consumption of the good depends positively on the fraction of other consumers in his own social group that consume the good. We first consider a benchmark case where the population of consumers is not segmented and constitutes one social group. We derive the optimal price and profit of the firm for this case. Next, we analyse the optimal price and profit for the case where the population of consumers is partitioned into two different social groups. Comparing the results for the cases with one and two social groups, it turns out that the partition into groups does not unambiguously gives the firm the opportunity to raise its price and increase its profit. The effects depend on a non-trivial interplay between the strength of the social interaction effect and the specific composition of the social groups.