

Mason, Charles F.

Working Paper

Optimal Contracts for Discouraging Deforestation with Risk Averse Agents

CESifo Working Paper, No. 7067

Provided in Cooperation with:

Ifo Institute – Leibniz Institute for Economic Research at the University of Munich

Suggested Citation: Mason, Charles F. (2018) : Optimal Contracts for Discouraging Deforestation with Risk Averse Agents, CESifo Working Paper, No. 7067, Center for Economic Studies and ifo Institute (CESifo), Munich

This Version is available at:

<https://hdl.handle.net/10419/180329>

Standard-Nutzungsbedingungen:

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

Terms of use:

Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.

Optimal Contracts for Discouraging Deforestation with Risk Averse Agents

Charles F. Mason

Impressum:

CESifo Working Papers

ISSN 2364-1428 (electronic version)

Publisher and distributor: Munich Society for the Promotion of Economic Research - CESifo GmbH

The international platform of Ludwigs-Maximilians University's Center for Economic Studies and the ifo Institute

Poschingerstr. 5, 81679 Munich, Germany

Telephone +49 (0)89 2180-2740, Telefax +49 (0)89 2180-17845, email office@cesifo.de

Editors: Clemens Fuest, Oliver Falck, Jasmin Gröschl

www.cesifo-group.org/wp

An electronic version of the paper may be downloaded

- from the SSRN website: www.SSRN.com
- from the RePEc website: www.RePEc.org
- from the CESifo website: www.CESifo-group.org/wp

Optimal Contracts for Discouraging Deforestation with Risk Averse Agents

Abstract

There is an emerging consensus that carbon emissions must be limited. An attractive approach to promoting carbon reductions is to encourage reductions in deforestation. But any such strategy must confront a basic problem: agents that might be induced to reduce their actions which would reduce forests have private information about their opportunity costs. This concern seems particularly likely to apply in situations where there are significant related risks, as agents seem highly likely to differ in their tolerance for risk. In this paper, I investigate a contracting scheme designed to mitigate the asymmetric information problem where agents are heterogeneous in their tolerance for risk. Mechanisms that recognize the potential insurance value associated with the acquisition of sequestration services, and that pay attention to landholders' private information about risk tolerance, offer a sensible way to approach the problem. These contracts are generally a cheaper approach to maintenance of forests than a simple, constant per-unit subsidy.

JEL-Codes: D040, D860, L150, Q540.

Keywords: incentive contracting, risk aversion, deforestation.

Charles F. Mason
Department of Economics
University of Wyoming
USA – Laramie, WY 82071
bambuzlr@uwyo.edu

May 13, 2018

1 Introduction

Reducing emissions of greenhouse gases to lessen the impact of future climate change is likely to result in large net benefits globally. However, reducing emissions will impose significant costs. Nordhaus (2008) estimates the costs of achieving optimal abatement of greenhouse gas emissions through control of industrial CO₂ emissions as \$2.2 trillion, which underscores the appeal of any scheme that might lower the costs of carbon reduction. One way to reduce costs that has received a great deal of attention is the use of offsets. The idea is that countries could meet emissions targets by substituting lower-cost offsets for reductions in emissions from energy production.

A particularly promising type of offset involves carbon sequestration in forests. Numerous studies have found that forest sequestration can be used to offset a substantial share of carbon emissions at costs that are similar to or lower than those associated with energy-based mitigation approaches (Richards and Stokes, 2004; van Kooten et al., 2004; Stavins and Richards, 2005). Other offset categories include carbon storage in agricultural soils and the transfer of clean energy technologies to developing countries not subject to emissions targets. Some types of forest and energy offsets are allowed under the Clean Development Mechanism (CDM) of the Kyoto Protocol, and there is interest in expanding their use under future agreements.¹

Despite their potential to reduce costs, offsets have a basic problem stemming from asymmetric information. Sellers of offsets have private information about their

¹ See, e.g., UNFCCC (2005). In principle, all carbon sources and sinks could be included under an emissions control policy, such as a cap-and-trade program. There are practical obstacles to this approach in the case of offsets from forests and agricultural lands due to the large and diverse population of landowners and apparent political obstacles—as suggested by the Kyoto Protocol negotiations—in the case of developing countries.

opportunity costs of mitigating or abating emissions. This implies that only the seller knows whether she would have undertaken the activity in the absence of a payment for the offset. This leads to the oft-expressed concern about “additionality”: offsets are not true incremental adjustments if they would have happened anyway.²

The additionality of offsets is important in two respects. First, governments will want to avoid paying for non-additional offsets in order to limit their expenditures.³ A number of studies have argued that government expenditures can reduce net social benefits if there are opportunity costs to raising public funds (Ballard and Fullerton, 1992; Bovenberg and Goulder, 1996; Browning, 1987; Dahlby, 2008). The government costs associated with purchases of offsets could be enormous. For example, in the U.S. an average of 1.3 million acres was deforested annually between 1982 and 1997 (USDA, 2000). While this produced significant carbon emissions that might be avoided at reasonable cost, one must consider that the area of (non-federal) forest in the U.S. is approximately 400 million acres. If the government were to implement a subsidy for avoided deforestation and apply it uniformly across all forested acres, then in the extreme case it would subsidize all forest land when less than 1% of the area would have been deforested. Of course, the government can avoid large expenditures by levying taxes instead of paying subsidies although this option seems unlikely to be politically viable, especially in the context of

² More generally, additionality arises whenever the government seeks to procure an impure public good from agents with private information. It has also been studied in the context of government subsidies for R&D and job creation (Picard, 2001; Gorg and Strobl, 2007).

³ One could argue that government expenditures are welfare-neutral, and thus economically irrelevant, because government costs are simply transfer payments from one set of agents in the economy to another. We have two responses. First, governments are commonly concerned with the budgetary effects of policies, as witnessed, for example, by debates over the size of the recent federal stimulus package in the U.S. Second, there are standard economic arguments that public funds have opportunity costs and, thus, reduce net social benefits.

private landowners in the U.S.

Second, to legitimately use offsets to meet emissions reduction targets, such as those stipulated under international treaties, the government must be able to verify that they are additional. Procedures that fail to clearly identify the increment of sequestration produced have been soundly criticized (Richards and Andersson, 2001), and, thus, concerns about additionality have been a stumbling block for inclusion of offsets, particularly those from avoided deforestation, in international efforts to address climate change (Plantinga and Richards, 2010). Even when a private entity such as a regulated emissions source purchases offsets, it faces the same problem as the government does with asymmetric information. As long as it is required to verify the purchase of additional offsets, a private entity will want to avoid paying for non-additional offsets as well as limiting its expenditures on the offsets that are additional. However, sellers have an incentive to exploit the asymmetric information by claiming to have high opportunity costs.

One obvious aspect of asymmetric information in the problem of encouraging avoided deforestation is the potential for agents to have heterogeneous risk attitudes. Highly risk averse agents would be easily attracted to offer forest sequestration services, as this shields them from any risk associated with developing the forest. Less risk averse agents, on the other hand, would need more substantial payments to offer forest sequestration services. As a result, the more risk averse agents have an incentive to claim higher risk tolerance. The problem then is one of inducing agents to truthfully reveal their risk attitudes, so as to avoid over-paying the more risk averse types.

In this paper, I focus my analysis on a government agency seeking to contract with private landowners to set parcels of land aside, guaranteeing the forests on that land will

not be harvested. The government's objective is to maximize expected net benefits from increased volumes of forest. Marginal benefits equal an exogenously determined value V that can be thought of as the marginal value of those forests in reducing carbon stocks. The nature of the optimal contracting scheme is related to key elements of the underlying distribution characterizing agents' risk attitudes. Each contract entails two ingredients, which can be interpreted as a price per unit of land set aside together with a land transfer from the agent to the Government. One fruitful way to think of such contracts is that they are analogous to insurance: the Government offers a fixed payment in exchange for the risky payment that would be confronted absent any Government purchase. For landowners that are particularly risk averse, such an arrangement can be very valuable, meaning the government would not need to pay a great deal to encourage participation. For other agents that are only mildly risk averse, the contract is less attractive, and hence willingness to pay to avoid risk is smaller. The essential feature of the contract scheme is that it induces agents to truthfully reveal their risk attitude. Based on this information, the government is able to minimize ex ante its expenditures on prevented deforestation.

In general, the optimal contract scheme is considerably less expensive than a uniform payment scheme. The implication is that the contract scheme will generally be strongly welfare-enhancing. These results have considerable practical importance, as they suggest sequestration contracts need not require huge governmental outlays. These contracts also identify ex post how much of the forestation undertaken by each agent is additional relative to what they would have done without a contract. This is the information a regulatory agency needs to ensure proper accounting of offsets credits.

My theoretical model adapts a standard principal-agent framework (Laffont and

Tirole, 1993; Salanié, 2005) to the problem at hand. The principal's objective is to maximize expected net societal benefits from afforestation and avoided deforestation (collectively, forestation), where forestation benefits are tied to an exogenously determined carbon price and costs are defined in terms of government expenditures. The problem may be regarded as one of adverse selection: the principal is assumed to know the distribution over landowners' opportunity costs, but not the realization for any particular individual; as a result, the amount of land any particular agent would have placed in forest absent a payment is not observed by the principal.⁴

2 Model

Suppose there is a governmental agency, which I term the "principal," that is interested in preventing deforestation. Each unit of land kept in forest generates an amount of sequestration, which yields a benefit V to the principal. This induced benefit can naturally be thought of as a value of marginal product, which depends on the price of carbon (which can either be explicit, if a formal carbon market exists, or implicit, as with an emissions trading scheme) and the marginal product of forest land in a sequestration production function.⁵ For expositional concreteness, I will occasionally refer to V as the "value of marginal product," with the understanding that this value is defined with respect to the

⁴ Viewed in this way, the problem is one of hidden information. van Benthem and Kerr (2010) consider a similar framework to mine, but do not consider the potential for the principal to reduce information rents by the use of two-part contracts; instead, they focus on the role of landowner size on contract efficiency. Using a variation of the law of large numbers, they argue that efficiency increases with the size of the landowner's holdings. Montero (2008) considers a problem in which the government wishes to buy a certain amount of offsets from a group of firms whose costs are private information; once a firm commits to a certain amount of offsets its actions can be perfectly monitored. In this framework, Montero constructs an auction mechanism that induces firms to perfectly reveal their cost curves.

⁵ This interpretation implicitly assumes that each acre of land stores the same quantity of carbon.

production of sequestration services. The land that may be placed in forest is managed by a private entity, whom we call the “agent.” In practice, the principal will interact with a number of agents; in the description of the model presented below I focus on the interaction with a canonical agent. Agents are characterized by their risk attitude; for expositional concreteness, I assume each type of agent exhibits constant relative risk aversion, so that their von Neumann Morgenstern utility function is

$$u(\pi) = \pi^{1-\theta}. \quad (1)$$

In this framework, θ is the index of relative risk aversion, which is private information to the agent. I assume that agents differ only in terms of their risk preference. In particular, the size and shape of the land they might protect from deforestation is not correlated with type. The set of agent types is $\Theta = [\underline{\theta}, \bar{\theta}]$ where $0 \leq \underline{\theta} < \bar{\theta} < 1$.

While the principal does not know any particular agent’s type, he does know the probability distribution function $f(\theta)$ over θ ,⁶ as well as the associated cumulative distribution function $F(\theta)$ and hazard rate

$$h(\theta) = \frac{f(\theta)}{1 - F(\theta)}.$$

I assume these functions are continuous in θ , and that $h'(\theta) > 0$.⁷

⁶ This may not be an innocuous assumption. For an analysis of a model in which the governmental agency does not know this distribution with certainty, see Bushnell (2011). An alternative to employing the optimal contracting approach we outline here would be to set a baseline level of activity, and pay agents for levels in excess of that baseline (Horowitz and Just, 2011). This baseline approach might result from ignorance regarding the distribution of firm types, or it could reflect institutional constraints that preclude the use of a contracting scheme such as the one we derive below.

⁷ The hazard rate is the conditional probability an agent’s type belongs to the interval $[\theta, \theta + d\theta]$, given the agent is known to be of type θ or larger. The condition $h'(\theta) > 0$ holds for many distributions, including

To focus the discussion, I suppose the contractual relation in question is one where the agent may sell the principal an easement for a fraction of her land x ; in this way, questions of permanence are finessed. If the agent sells a fraction x of her land she collects a known payment $R(x)$ for that parcel.⁸ The value associated with any residual fraction of land $1 - x$ is stochastic. One can think of uncertain future payoffs associated with transforming the land into some alternative use, perhaps croplands or development; the value associated with that future alternative is unknown. For simplicity, I suppose there are two possible values the land may take after this uncertainty is resolved, namely p_1 and p_2 ; the probabilities of these outcomes are λ and $1 - \lambda$, respectively. I define for later use

$$\bar{p} \equiv \lambda p_1 + (1 - \lambda)p_2,$$

the expected value of the stochastic payment. An agent of type θ that opts out of any easement contract, and so places all her land in the risky category, obtains a payoff equal to her expected utility

$$\begin{aligned} EU_0(\theta) &= \lambda u(p_1) + (1 - \lambda)u(p_2) \\ &= \lambda p_1^{1-\theta} + (1 - \lambda)p_2^{1-\theta}. \end{aligned}$$

The principal's goal is to maximize expected net social surplus, which is the sum of the imputed value of land placed into easement, Vx , plus the expected utility earned by the agent, $EU(x, p; \theta)$, less the net cost of acquisition, which depends on the social cost

the one I employ in the empirical application below.

⁸ It will occasionally be expositionally convenient to think of this payment as combining a per-unit payment p and a transfer T , so that $R(x) = p(x)x - T(x)$. At first blush, this would seem to introduce an extra degree of freedom. But as I note below, the agent's optimal choice of x can be expressed in terms of p and T . Thus, there is a unique combination of p and T that would correspond to R , subject to the constraint that x is privately optimal for the agent given that combination of p and T .

of raising a dollar of government funds, $\mu > 1$.⁹ Thus, the principal's objective functional is

$$\Omega \equiv \int_{\underline{\theta}}^{\bar{\theta}} (Vx(\theta) - \mu R(\theta) + EU(x, p; \theta)) f(\theta) d\theta,$$

where $x(\theta)$ is the amount of land an agent of type θ places in forest and $R(\theta) = R(x(\theta))$ is the payment to the agent. Note that the agent's type is the only source of randomness in the principal's objective function. I assume that the value to the principal and social cost of funds are such that $V < \mu\bar{p}$; if this were not true the problem would be trivial, in that the principal would offer a per-unit price of \bar{p} to all agents (possibly with a fixed transfer from the agent), and so acquire all land.

3 Landowner Behavior

Because landowners are risk averse, they can benefit from selling part of their land to the government. Doing so allows the landowner to shed some of the risk associated with the uncertain potential future payoffs. The value of reducing this risk will differ by amount of land sold and by the agent's attitudes towards risk. In particular, if the landowner is

⁹ The marginal cost of public funds summarizes the distortion in resource allocation that arises when the government funds its expenditures by raising taxes (Dahlby, 2008, p. 1). While its particular value depends on a host of assumptions regarding labor market elasticities, inter-temporal consumption elasticities and taxation method, there seems to be a consensus that the value will be larger than 1.1. For example, Browning (1987) estimates its value as between 1.1 and 4.0; Ballard and Fullerton (1992) find values between 1.1 and 1.99 (if funds are raised by increasing marginal tax rates); and Dahlby (2008, Table 6.1, p. 150) suggests a range between 1.150 and 1.557. In a numerical evaluation of environmental taxes, Bovenberg and Goulder (1996, Table 4) suggest that realistic values might fall between 1.11 and 1.41. While these various pieces of evidence suggest a broad range of potential values, most estimates fall below 1.5; our choice of 1.3 represents something of a compromise between the lower bound of 1.1 and this apparent upper bound of 1.5.

able to sell a fraction x at an average price \tilde{p} , her expected utility becomes

$$EU(x, \tilde{p}) = \lambda u((1-x)p_1 + \tilde{p}x) + (1-\lambda)u((1-x)p_2 + \tilde{p}x).$$

For the specified amount of land to be transferred, the agent's reservation price p^r sets this expected utility equal to the *ex ante* expected utility EU_0 :

$$\lambda u((1-x)p_1 + p^r x) + (1-\lambda)u((1-x)p_2 + p^r x) = \lambda u(p_1) + (1-\lambda)u(p_2).$$

With the iso-elastic utility function in (1), p^r is implicitly defined by

$$\lambda((1-x)p_1 + p^r x)^{1-\theta} + (1-\lambda)((1-x)p_2 + p^r x)^{1-\theta} = \lambda p_1^{1-\theta} + (1-\lambda)p_2^{1-\theta}. \quad (2)$$

In general, this reservation price is upward-sloping in x , and $p^r = \bar{p}$ at $x = 1$ for all θ , *i.e.*, at the actuarially fair price. Although all agents equally value the last increment of land, more risk averse types would accept lower prices for smaller fractions. Alternatively, viewing the principal's purchase as a form of insurance, more risk averse agents would be willing to pay more for insurance, particularly when the level of insurance is large. Moreover, so long as the worst outcome p_2 yields a positive payoff, the reservation price for the first increment of land is positive, and declining in θ , the index of relative risk aversion.

I illustrate these effects in Figure 1. The diagram is based on an example with equally likely states ($\lambda = \frac{1}{2}$), where the outcomes are $p_1 = .9, p_2 = .1$. Thus, the expected value of a unit of land is $\bar{p} = \frac{1}{2}$. In this diagram, I show the reservation prices for three

types of agents, with risk aversion parameters $\theta = \frac{1}{4}$ (the dashed curve), $\frac{1}{2}$ (the solid curve) and $\frac{3}{4}$ (the curve marked with dots, short dashes and long dashes). A key point here is that more risk averse agents would supply land more elastically and at lower prices than would relatively risk tolerant agents. That agents differ in terms of their supply elasticities suggests that a buyer might be able to benefit from price discrimination, in particular by demanding a larger transfer payment from more risk averse agents.

To expand on this theme, imagine an agent with index of relative risk aversion θ who has been offered a payment scheme $R(x)$. Such an agent would wish to transfer the amount of land:

$$x^*(\theta) = \mathbf{argmax} \left\{ \lambda \left((1-x)p_1 + R(x) \right)^{1-\theta} + (1-\lambda) \left((1-x)p_2 + R(x) \right)^{1-\theta} \right\}.$$

Proceeding directly, it is straightforward to characterize the optimal amount x^* :

$$\lambda \left((1-x^*)p_1 + R(x^*) \right)^{-\theta} \left(R'(x^*) - p_1 \right) + (1-\lambda) \left((1-x^*)p_2 + R(x^*) \right)^{-\theta} \left(R'(x^*) - p_2 \right) = 0. \quad (3)$$

The behavioral rule in eq. (3) serves as a constraint on the principal's choice of contracts.

Before moving on to a discussion of the principal's optimal menu of contracts, I note that if the contract is linear, so that $R = px - T$, there is an equivalence between contracts quoted as combinations (p, T) and contracts quoted as combinations (x, R) . In this case, the optimal level of land transferred to the principal can be expressed as

$$x(p, T; \theta) = \frac{p_1 \Lambda(p) - p_2 + T(1 - \Lambda(p))}{p_1 \Lambda(p) - p_2 + p(1 - \Lambda(p))}, \quad (4)$$

where

$$\Lambda(p) = \left[\left(\frac{1-\lambda}{\lambda} \right) \left(\frac{p-p_2}{p_1-p} \right) \right]^{\frac{1}{\theta}}.$$

It is easy to see that $\Lambda \leq 1$ when $p \leq \bar{p}$, as is the case here, with strict inequality when $p < \bar{p}$.

Moreover, when $p \in (p_2, p_1)$, again as will be the case in this problem, then Λ is strictly positive.

4 Optimal contracts

The government wishes to maximize its objective functional Ω , expected net social surplus.

To accomplish this goal it designs a menu of contracts of the form $\{x(\theta), R(\theta)\}$. The choice of contract menu is subject to an incentive compatibility constraint: intuitively, an agent can guarantee a positive payoff by imitating a lower type agent; to induce the agent to accept the contract intended for his type, the agent must receive some of the rent, commonly referred to as an *information rent* in the literature.

To characterize this incentive compatibility constraint, I denote the expected utility earned by a type θ agent who chooses the contract intended for a type $\hat{\theta}$ agent by $EU(\hat{\theta}, \theta)$. The incentive constraint requires that each type of agent finds it optimal to select the contract intended for her type, *i.e.*, that EU is maximized at $\hat{\theta} = \theta$. Making use of the functional form in eq. (1), the impact of a slight change in the announced type upon payoffs can be expressed as

$$\partial EU(\hat{\theta}, \theta) / \partial \hat{\theta} = \lambda \partial \pi_1(\hat{\theta})^{1-\theta} / \partial \hat{\theta} + (1-\lambda) \partial \pi_2(\hat{\theta})^{1-\theta} / \partial \hat{\theta},$$

where

$$\pi_k(\hat{\theta}) = p_k(1 - x(\hat{\theta})) + R(\hat{\theta}).$$

The incentive compatibility constraint is that this marginal effect vanishes when evaluated at $\hat{\theta} = \theta$. Straightforward algebra yields:

$$[\lambda\pi_1^{-\theta} + (1 - \lambda)\pi_2^{-\theta}]R'(\theta) = [\lambda p_1\pi_1^{-\theta} + (1 - \lambda)p_2\pi_2^{-\theta}]x'(\theta).$$

Then, since $R(\theta) = R(x(\theta))$, one may derive:

$$R'(x) = \left(\frac{\lambda\pi_1^{-\theta}}{\lambda\pi_1^{-\theta} + (1 - \lambda)\pi_2^{-\theta}} \right) p_1 + \left(\frac{\lambda\pi_2^{-\theta}}{\lambda\pi_1^{-\theta} + (1 - \lambda)\pi_2^{-\theta}} \right) p_2. \quad (5)$$

As this constraint must be satisfied for all θ , it induces a differential equation for $R(x)$; the solution to this differential equation gives the revenue function $R(x)$ that the principal's optimal contract menu must honor.

I next define the information rents earned by an agent of type θ as

$$v(\theta) \equiv EU(\theta, \theta) - EU_0(\theta).$$

Making use of this construct, the principal's objective functional may be rewritten as

$$\Omega \equiv \int_{\underline{\theta}}^{\bar{\theta}} [Vx(\theta) - \mu R(x(\theta)) + EU_0(\theta)] f(\theta) d\theta - \int_{\underline{\theta}}^{\bar{\theta}} -v(\theta) f(\theta) d\theta.$$

The optimal contract scheme is subject to the incentive compatibility constraint. Since all

payments are linked to the payments offered to the least risk-averse agent, it follows that the optimal scheme reduces this agent's information rents to zero, *i.e.*, $v(\underline{\theta}) = 0$; this forms a sort of boundary condition. Then, applying integration by parts to the second integral while noting that $v(\theta)(1 - F(\theta)) = 0$ at both $\theta = \bar{\theta}$ (since $F(\bar{\theta}) = 1$) and $\theta = \underline{\theta}$ (since $v(\underline{\theta}) = 0$) yields¹⁰

$$\Omega = \int_{\underline{\theta}}^{\bar{\theta}} \left\{ Vx(\theta) - \mu R(x(\theta)) + EU_0(\theta) + v'(\theta) \left(\frac{1 - F(\theta)}{f(\theta)} \right) \right\} f(\theta) d\theta. \quad (6)$$

It is now straightforward to derive the elements in the optimal menu of contracts: one simply maximizes Ω element by element, for each value of θ . Because the contract choice induces a level of land, one can view the problem as one of determining the principal's optimal level of x at each θ , subject to the behavioral constraint posed by eq. (4). Taking this interpretation, one obtains the first-order conditions for an interior solution:

$$V - \mu R'(x) + \frac{1 - F(\theta)}{f(\theta)} \frac{\partial v'(\theta)}{\partial x} = 0. \quad (7)$$

Notice that this condition dictates $R'(x(\bar{\theta})) = V/\mu$, as by definition $F(\bar{\theta}) = 1$.

The optimal contract scheme can also be thought of as the solution to a system of two first-order differential equations, one induced by the observation that the left-hand side of eq. (7) must not change as θ is varied, and the other given by the incentive constraint eq. (5). The solution to this system of differential equations is pinned down by two boundary conditions. One boundary condition is induced by the stipulation that $v(\underline{\theta}) = 0$, while the other comes from the requirement that $p(\bar{\theta}) = V/\mu$.

¹⁰ Details regarding the information rent function, and the effect of x upon marginal information rents, are relegated to Appendix A.

5 Graphical Illustration

To illustrate the mechanics of the optimal contracting scheme, consider a stripped down version of the problem, with two agent types: $\theta \in \{.25, .75\}$. The risky prospect landowners start with is described by the two prices $p_1 = .9, p_2 = .1$, which I suppose are equally likely. With these parameters, it is easy to check that the *ex ante* expected utilities are $EU_0 = .551$ for $\theta = .25$ and $EU_0 = .768$ for $\theta = .75$. The first aspect of the optimal contract scheme is the restriction that the least risk-averse agent earn zero information rents, *i.e.*, that she is indifferent between accepting the contract or not accepting the contract. This means the optimal contract for the agent of type $\underline{\theta}$ leaves her on the iso-expected utility curve that goes through the initial payoff combination (the point labeled “endowment” in the figure). At this contract, the type $\underline{\theta}$ sells some land but retains most of it; as a result, the payoff she would earn in state 1 (where the unit value of land turns out to be p_1) is much larger than the payoff she would earn in state 2 (where the unit value of land turns out to be p_2). The combination of these payoffs is indicated as “induced by contract for type $\theta = .25$ in the figure. Because the other type of agent can also adopt this contract, she must obtain the same expected utility as at this contract; this realization places the optimal contract for the type $\bar{\theta}$ agent on the iso-expected utility curve labeled “ $EU_1(\theta = .75)$.” The optimal per-unit payment to this type of agent, V/μ , reflects the value of land to the principal, as well as the social cost of funds, and induces the type $\bar{\theta}$ agent to transfer most (though not all) of her land to the government. Accordingly, the payoff she would earn in state 1 (where the unit value of land turns out to be p_1) is only slightly larger than the payoff she would earn in state 2 (where the unit value of land turns out to be p_2). The combination

of these payoffs is indicated as “induced by contract for type $\theta = .75$ in the figure.

Next, consider an example with three agent types. Figure 3 illustrates the mechanics. As with two types, the least risk-averse agent is induced to select a contract that leaves her on the iso-expected utility curve that goes through the endowment point, and the most risk-averse agent is induced to select a contract that pays her V/μ per unit of land, and at which she chooses to sequester most of her land. Also as in the two agent type example, the most risk-averse agent winds up on an iso-expected utility curve, labeled as $IC_{\bar{\theta}}$ in the figure, that goes through the payoff combination the next less risk averse agent chooses. I call this other agent type θ_2 below. With three agent types, the type θ_2 agent type is more risk averse than the type $\underline{\theta}$ agent, and so this type of agent is induced to select the contract induces a profit combination that lies on *her* iso-expected utility curve that goes through the payoff combination the least risk averse agent winds up with. This curve is labeled as $IC_{\theta=\theta_2}$ in the figure.

In general, the price paid to the type $\bar{\theta}$ agent, together with the incentive compatibility constraint, induces a family of sequences of combinations of price and transfer for all agent types; every member of this family is associated with a particular price paid to the least risk averse agent type. The optimal contract scheme picks out the sequence in this family that delivers the largest expected payoff to the principal.

6 Conclusion

Carbon offsets are a promising approach to reducing the global costs of climate change mitigation, but additionality presents significant obstacles. Besides additionality concerns,

it is important that payments do not impose substantial costs on government; otherwise international efforts to promote such schemes will likely be compromised. In particular, I think it is important to recognize that offset contracts provide a variant of insurance in that they allow landholders to shed some of the risk associated with holding the land. I think it highly unlikely that landholders are homogeneous with respect to their risk tolerance. Moreover, an agent's risk tolerance is quintessentially private information. Accordingly, I think there is a real concern that poorly designed mechanisms will be unnecessarily expensive vehicles for delivering forest sequestration services.

Mechanisms that recognize the potential insurance value associated with the acquisition of sequestration services, and that pay attention to landholders' private information about risk tolerance, offer a sensible way to approach the problem. In this paper, I have proposed such a contracting scheme. The scheme I propose will encourage carbon offsets from forestation at minimal cost to the government, subject to the landholders having private information about their risk attitudes. These contracts typically leave some rents in landowners' hands, and so are second-best in nature. But the contracts are generally a cheaper approach to maintenance of forests than a simple, constant per-unit subsidy.¹¹

While I analyze optimal contracts when the government purchases offsets, one can imagine cases in which private agents would be the buyers. For example, if energy producers are subject to emissions restrictions, they may be allowed to substitute lower-cost offsets for emissions reductions. In this case, the regulating agency will want to ensure

¹¹ In a national-scale simulation, Mason and Plantinga (2013) find that for given increases in forest area government expenditures with contracting are about 40% of those with subsidies. In absolute terms, contracts lower expenditures by over \$5 billion per year when applied to 60 million acres of land. Since the contracting scheme does not satisfy the equi-marginal principle, private opportunity costs are necessarily higher than under the uniform subsidy. However, we find that this difference is small (about \$100 million for a 60 million acre increase) relative to the reductions in expenditures.

that the offsets are additional since non-additional offsets would effectively relax the emissions controls. In this setting, non-additional offsets would be inexpensive and, thus, particularly appealing to emissions sources. If the private agent acts as a monopsonist in the offset market, as the government does in our model, our contracting scheme is a direct remedy for this problem. The regulating agency could require private buyers of offsets to structure contracts following our design. Conditional on their purchasing only additional offsets, private buyers would want to implement our scheme because it minimizes their costs. Future research is needed to investigate the performance of contracts in a competitive market with many private purchasers of offsets.

References

- Ballard, C. L. and Fullerton, D. (1992). Distortionary taxes and the provision of public goods, *The Journal of Economic Perspectives* **6**: 117–131.
- Bovenberg, A. L. and Goulder, L. H. (1996). Optimal environmental taxation in the presence of other taxes: General- equilibrium analyses, *American Economic Review* **86**: 985–1000.
- Browning, E. K. (1987). On the marginal welfare cost of taxation, *The American Economic Review* **77**: 11–23.
- Bushnell, J. B. (2011). Adverse selection and emissions offsets. Energy Institute at Haas Working Paper 222.
- Dahlby, B. (2008). *The Marginal Cost of Public Funds*, MIT Press, Cambridge, MA.
- Gorg, H. and Strobl, E. (2007). The effect of r&d subsidies on private r&d, *Economica* **74**: 215–234.
- Horowitz, J. and Just, R. (2011). Economics of additionality for environmental services. U.S. Department of Agriculture Working Paper.
- Laffont, J.-J. and Tirole, J. (1993). *A Theory of Incentives in Procurement and Regulation*, MIT Press, Cambridge, MA.
- Mason, C. F. and Plantinga, A. P. (2013). The additionality problem with offsets: Optimal contracts for carbon sequestration in forests, *Journal of Environmental Economics and Management* . forthcoming.

- Montero, J.-P. (2008). A simple auction mechanism for the optimal allocation of the commons, *American Economic Review* **98**: 496–518.
- Nordhaus, W. D. (2008). *A Question of Balance*, Yale University Press, New Haven, CT.
- Picard, P. M. (2001). Job additionality and deadweight spending in perfectly competitive industries: The case for optimal employment subsidies, *Journal of Public Economics* **79**: 521–541.
- Plantinga, A. J. and Richards, K. R. (2010). International forest carbon sequestration in a post-kyoto agreement, in J. E. Aldy and R. N. Stavins (eds), *Post-Kyoto International Climate Policy*, Cambridge University Press, New York, NY.
- Richards, K. R. and Andersson, K. (2001). The leaky sink: Persistent obstacles to a forest carbon sequestration program based on individual projects, *Climate Policy* **1**: 41–54.
- Richards, K. R. and Stokes, C. (2004). A review of forest carbon sequestration cost studies: A dozen years of research, *Climatic Change* **63**: 1–48.
- Salanié, B. (2005). *The Economics of Contracts: A Primer*, 2 edn, MIT Press, Cambridge, MA.
- Stavins, R. N. and Richards, K. R. (2005). The cost of U.S. forest based carbon sequestration. Prepared for the Pew Center for Global Climate Change.
- UNFCCC (2005). Reducing emissions from deforestation in developing countries: Approaches to stimulate action. UNFCCC:FCCC/CP/2005/MISC.1.
- USDA (2000). *Summary Report: 1997 National Resources Inventory*, Natural Resources Conservation Service, Washington, DC.

van Benthem, A. and Kerr, S. (2010). Optimizing voluntary deforestation policy in the face of adverse selection and costly transfers. Motu Economic and Public Policy Research Working Paper 10-04.

van Kooten, G. C., Eagle, A. J., Manley, J. and Smolakvan, T. (2004). How costly are carbon offsets? a meta-analysis of forest carbon sinks., *Environmental Science and Policy* 7: 239–251.

Appendix A

Making use of eqs. (1) and (5), the effect of a small change in θ upon information rents can be expressed as:

$$\begin{aligned} v'(\theta) &= \frac{\partial EU(\hat{\theta}, \theta)}{\partial \theta} \Big|_{\hat{\theta}=\theta} - EU'_0(\theta) \\ &= \lambda [\ln(p_1)p_1^{1-\theta} - \ln(\pi_1)\pi_1^{1-\theta}] - (1-\lambda) [\ln(\pi_2)\pi_2^{1-\theta} - \ln(p_2)p_2^{1-\theta}]. \end{aligned} \quad (8)$$

One may then derive the marginal impact of x upon marginal information rents as

$$\begin{aligned} \frac{\partial v'(\theta)}{\partial x} &= \lambda p_1 \pi_1^{-\theta} [1 + (1-\theta)\ln(\pi_1)] + (1-\lambda) p_2 \pi_2^{-\theta} [1 + (1-\theta)\ln(\pi_2)] \\ &\quad - \left\{ \lambda \pi_1^{-\theta} [1 + (1-\theta)\ln(\pi_1)] + (1-\lambda) \pi_2^{-\theta} [1 + (1-\theta)\ln(\pi_2)] \right\} R'(x). \end{aligned}$$

Combining with eq. (5), one then has

$$\frac{\partial v'(\theta)}{\partial x} = (1-\theta) \left\{ \lambda \pi_1^{-\theta} \ln(\pi_1) [p_1 - R'(x)] + (1-\lambda) \pi_2^{-\theta} \ln(\pi_2) [p_2 - R'(x)] \right\}. \quad (9)$$

To facilitate an explanation of the monotonically negative relation between the elasticity of agents' willingness to supply land and relative risk aversion, suppose that $p_2 = 0$. Then $EU_0 = \lambda p_1^{1-\theta}$ and $EU(x, p^r) = \lambda (p_1 + (p^r - p_1)x)^{1-\theta} + (1-\lambda)(p^r x)^{1-\theta}$. Setting these equal gives the implicit relation that defines p^r :

$$1 = \lambda \left(1 + \left(\frac{p^r}{p_1} - 1 \right) x \right)^{1-\theta} + (1-\lambda) \left(\frac{p^r}{p_1} x \right)^{1-\theta}.$$

Let $\tau \equiv \frac{p^r}{p_1}x$, and totally differentiate with respect to τ and x to get

$$0 = \lambda(1-x+\tau)^{-\theta} [d\tau - dx] + (1-\lambda)(\tau)^{-\theta} d\tau.$$

It follows that

$$\begin{aligned} \frac{p^r}{p_1} + \frac{x}{p_1} \frac{dp^r}{dx} = \frac{d\tau}{dx} &= \frac{\lambda(1-x+\tau)^{-\theta}}{\lambda(1-x+\tau)^{-\theta} + (1-\lambda)(\tau)^{-\theta}} \\ &= \frac{\lambda}{\lambda + (1-\lambda)\left(1 + \frac{1-x}{\tau}\right)^\theta} \end{aligned}$$

which is clearly decreasing in θ . Finally, it is easy to see that the elasticity of supply with respect to p^r is positively related to this expression.

Figure 1: The Relation of Agents' Reservation Prices to Risk Aversion

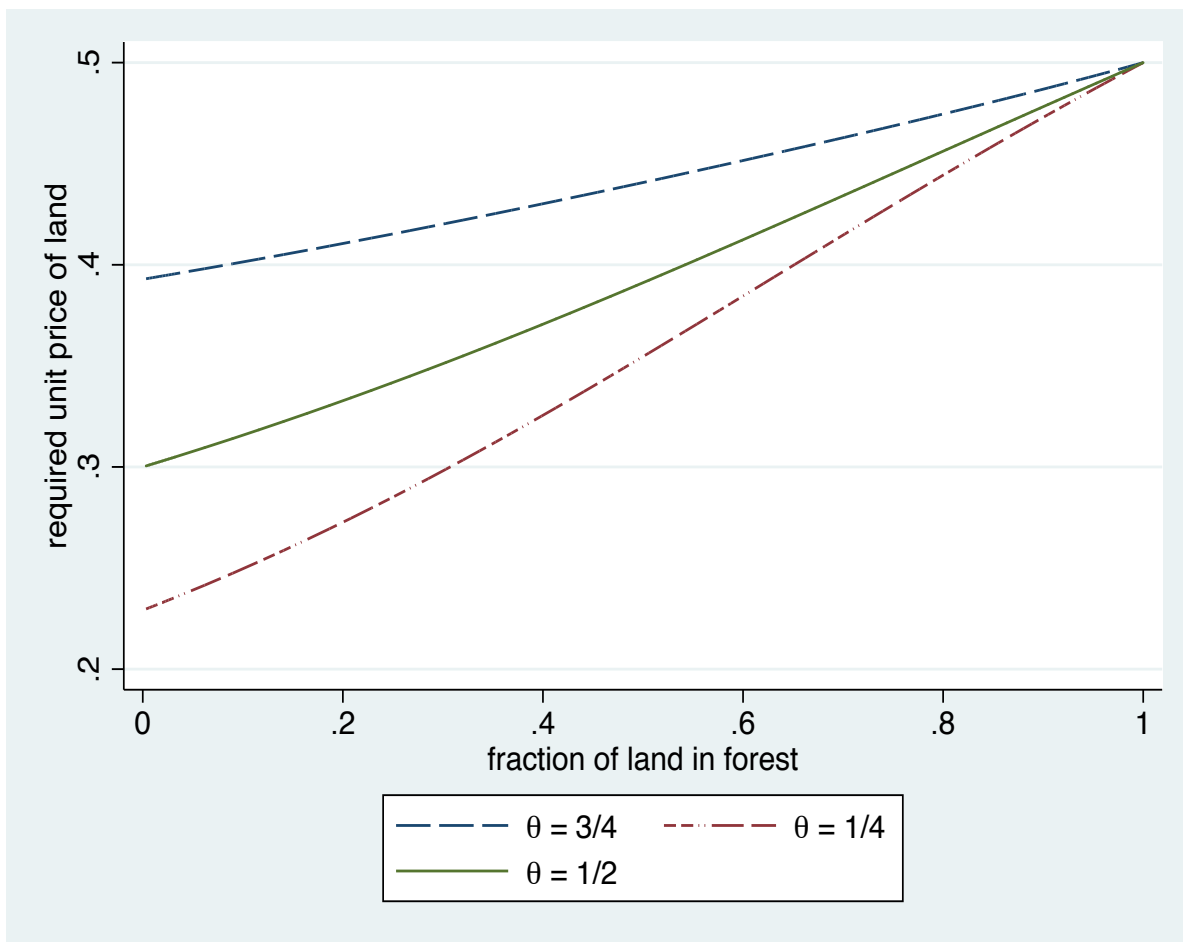


Figure 2: Optimal contracts with two types of agents

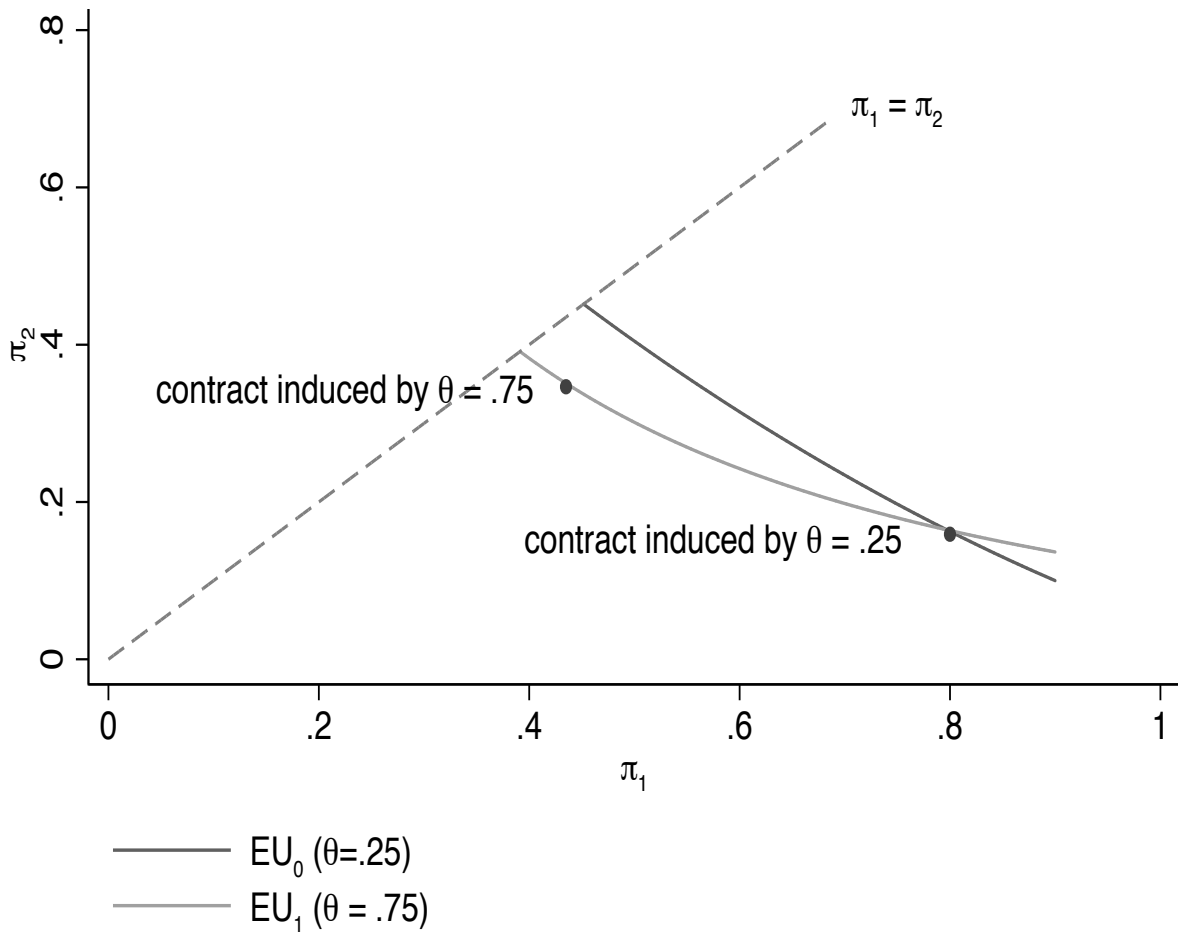


Figure 3: Optimal contracts with three types of agents

