

Rosenkranz, Stephanie; Schmitz, Patrick W.

Working Paper

Can Coasean bargaining justify Pigouvian taxation?

Bonn Econ Discussion Papers, No. 7/2006

Provided in Cooperation with:

Bonn Graduate School of Economics (BGSE), University of Bonn

Suggested Citation: Rosenkranz, Stephanie; Schmitz, Patrick W. (2006) : Can Coasean bargaining justify Pigouvian taxation?, Bonn Econ Discussion Papers, No. 7/2006, University of Bonn, Bonn Graduate School of Economics (BGSE), Bonn

This Version is available at:

<https://hdl.handle.net/10419/22952>

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.

BONN ECON DISCUSSION PAPERS

Discussion Paper 7/2006

Can Coasean bargaining justify Pigouvian taxation?

by

Stephanie Rosenkranz, Patrick W.
Schmitz

February 2006



Bonn Graduate School of Economics
Department of Economics
University of Bonn
Adenauerallee 24 - 42
D-53113 Bonn

The Bonn Graduate School of Economics is
sponsored by the

Deutsche Post  World Net
MAIL EXPRESS LOGISTICS FINANCE

Can Coasean bargaining justify Pigouvian taxation?

Stephanie Rosenkranz^a and Patrick W. Schmitz^{b,*}

^a *University of Utrecht and CEPR*

^b *University of Bonn and CEPR*

Abstract

The fact that according to the celebrated Coase Theorem rational parties always try to exploit all gains from trade is usually taken as an argument against the necessity of government intervention through Pigouvian taxation in order to correct externalities. However, we show that the hold-up problem, which occurs if non-verifiable investments have external effects and parties cannot be prevented from always exploiting ex post gains from trade through Coasean bargaining, may be solved by government intervention. In this sense, the impossibility to rule out Coasean bargaining (after investments are sunk) may in fact justify Pigouvian taxation.

Keywords: Hold-up problem; Bargaining; Contracts; Taxation; Externalities

JEL classification: D62; H21; H23; L14

*Corresponding author: Patrick W. Schmitz, University of Bonn, Wirtschaftspolitische Abteilung, Adenauerallee 24–42, D-53113 Bonn, Germany. E-mail address: <patrick.schmitz@uni-bonn.de>. Homepage URL: <<http://center.wipol.uni-bonn.de/~schmitz/>>. We have benefitted from helpful discussions with Andreas Roider, Urs Schweizer, and Philipp Wichardt.

1 Introduction

A standard textbook argument known by every student of public economics goes as follows.¹ If the activity of party A has an uncompensated external effect on party B 's utility, then party A will not choose the socially efficient activity level. Party A can be made to internalize the externality by Pigouvian taxation. However, opponents of government intervention typically argue that Pigouvian taxation is not necessary. According to the celebrated Coase Theorem, rational parties always exploit all possible gains from trade, provided there are no frictions (specifically, if there is symmetric information).² They will hence write a contract that induces party A to choose the efficient activity level and divide the gains from trade by appropriate transfer payments. Thus, if one does not make the assumption that the government has better information than the parties themselves (which many economists consider to be unrealistic), Coasean bargaining makes Pigouvian taxation unnecessary.

In contrast, in this paper we will argue that the very fact that (under frictionless conditions) rational parties always engage in Coasean bargaining in order to exploit all gains from trade, can indeed justify government intervention.

Specifically, we consider a hold-up problem, where a party can make a relationship-specific investment ex ante, that enhances the gains from trade that can be realized ex post.³ The investment is non-verifiable, i.e. the Coase Theorem clearly is inapplicable at the ex ante stage, before the investment is made. However, it is a standard assumption in the literature on the hold-up problem that at the ex post stage, after the investment has been sunk, there are no more frictions (in particular, there is

¹See e.g. Mas-Colell, Whinston, and Green (1995, p. 354) for a modern textbook treatment. See also the seminal contributions by Pigou (1932) and Coase (1960).

²In a seminal paper, Myerson and Satterthwaite (1983) have shown that bargaining can in general not always lead to an ex post efficient outcome if there is asymmetric information.

³For discussions of the hold-up problem, see e.g. Hart (1995) and Tirole (1999). See also Schmitz (2001) for a non-technical survey of the literature.

symmetric information).⁴ Hence, the parties always engage in Coasean bargaining in order to exploit all ex post gains from trade. If investments have direct externalities and if the investing party has not all bargaining power ex post, then the hold-up problem cannot be solved contractually, precisely because Coasean bargaining at the ex post stage cannot be prevented, as has first been shown by Maskin and Moore (1999). The contribution of the present paper is to argue that, ironically, under these circumstances Pigouvian taxation can help to solve the hold-up problem.

In order to convey the intuition for our argument, consider the following simple example, which is based on Maskin and Moore (1999). There are two risk-neutral parties, a producer and a buyer. At date 1, the producer can decide whether or not to exert effort (i.e., invest) while producing one unit of an indivisible good, which can be traded with the buyer at date 2. If the producer does not exert effort at date 1, the buyer's willingness-to-pay for the good is v_l . If the producer exerts effort at a personal disutility cost $c > 0$, then the buyer's valuation is v_h , where $v_h > v_l > 0$. The producer has no further costs. Notice that the producer's effort has a direct externality on the buyer's valuation $v \in \{v_l, v_h\}$. If the producer were not compensated, she would never exert effort. However, exerting effort is socially efficient provided that $v_h - v_l > c$, which we assume in what follows.

Let effort (and hence the buyer's valuation) be observable by the two parties, but unverifiable to outsiders such as the courts. Even though effort is thus non-contractible, it might be possible for the parties to ex ante write a contract which induces the producer to invest by giving the buyer an option to buy the good at date 2, with a strike price of v_h . The idea is that the buyer would only exercise the option if the producer had exerted effort, and the producer would exert effort because she would then get the total surplus $v_h - c$. Yet, there is a problem. Suppose that the

⁴The standard assumption that there is frictionless ex post bargaining has recently been sharply criticized by Williamson (2000, 2002), who considers this point to be a crucial difference between the so-called property rights approach (which builds on the hold-up problem, see Hart, 1995) and transaction costs economics. See Schmitz (2006) for a first attempt to model asymmetric information as a source of transaction costs at the ex post stage.

producer had exerted effort, so that the buyer's valuation is v_h . If the buyer exercises the option, he receives zero. But if he does not exercise, there would still remain gains from trade to be exploited, since $v_h > 0$. Thus, in accordance with the Coase Theorem, the parties would start to bargain. Let the outcome of the negotiations be given by the Nash bargaining solution, so that each party would get $\frac{1}{2}v_h$ at date 2. If the producer had not exerted effort, a similar reasoning shows that each party would get $\frac{1}{2}v_l$. Hence, the producer would not exert effort if $\frac{1}{2}(v_h - v_l) < c$. In fact, Maskin and Moore (1999) prove that there is no ex ante contract the parties could write which induces effort if this inequality holds. This is the hold-up problem in its most severe form.

We will now show that the hold-up problem, which is caused by the direct externality of the producer's effort and the fact that parties always exploit all gains from trade (which makes threats of ex post inefficient outcomes incredible), can in fact be solved by government intervention. Notice that we do *not* assume that the government can observe otherwise non-verifiable information. Hence, we do not condition the tax on the producer's effort or the buyer's true valuation.⁵ Instead, consider the following tax scheme. The buyer must pay $t(v_h - z)$ to the government, where $t \in (0, 1)$ denotes the tax rate. What is important here is that any payment z that the buyer makes to the producer is deductible;⁶ i.e., the buyer's net payoff is $xv - tv_h - (1 - t)z$, where $x \in \{0, 1\}$ denotes the parties' trade decision. Assume that the parties have written no contract ex ante, which will turn out to be optimal. Then they will always negotiate at date 2. We continue to assume that the outcome of the negotiations is

⁵Since the producer's effort has a positive externality, a naive Pigouvian solution would be to directly subsidize effort. This is not feasible because effort is unverifiable, so that a solution must be sought which circumvents this problem.

⁶Transfer payments are usually assumed to be verifiable in the hold-up literature. Of course, whenever a taxpayer can deduct expenditures, there is a danger of fraudulent tax evasion (the buyer might overstate the true expenses, perhaps colluding with the seller). For simplicity, we assume that this could be detected by auditing and is deterred by sufficiently high penalties. (Our findings hold qualitatively as long as tax audits are not completely ineffective.)

given by the Nash bargaining solution. The producer's and the buyer's threatpoint payoffs (what they get if negotiations fail) are 0 and $-tv_h$, respectively. Thus, the parties will always agree to trade ($x = 1$) and choose the payment that maximizes the Nash product $(z - 0)(v - tv_h - (1 - t)z + tv_h)$,⁷ so that

$$z = \frac{v}{2(1 - t)}.$$

Anticipating the bargaining outcome, the producer will exert effort if and only if

$$\frac{1}{2(1 - t)}(v_h - v_l) \geq c.$$

Therefore, if $t = \frac{1}{2}$, the producer will invest whenever it is socially efficient to do so and thus the hold-up problem has been solved.⁸

It will turn out that our argument can be generalized considerably. In particular, effort and valuation do not have to be binary variables, the relationship between effort and valuation does not have to be deterministic, and the parties' bargaining powers do not have to be equal. We will also discuss extensions of our set-up, where a simple tax-subsidy scheme can alleviate the hold-up problem, even if the government does not know the parties' bargaining powers, or if the seller may incur further costs at the ex post stage, or if there are two-sided investments. In each case, even though the government cannot change the parties' bargaining powers, taxation can change the set of feasible ex post outcomes, so that the outcome of ex post bargaining can be influenced by the government.

To the best of our knowledge, this is the first paper which argues that the hold-up problem, which is caused by unverifiable investments with direct externalities and, ironically, by the fact that (at the ex post stage) Coasean bargaining always exploits all gains from trade, can be solved by a simple form of Pigouvian taxation.

⁷For an exposition of the Nash product and the Nash bargaining solution, see e.g. Muthoo (1999). It should be noted that even though Nash bargaining is a standard assumption in the contract theoretic literature, it might be more difficult to provide a strategic justification in a framework without commitment (cf. Muthoo, 1990).

⁸Note that in equilibrium the tax revenue is zero.

The hold-up problem has played a prominent role in recent contract-theoretic research. In particular, Maskin and Moore (1999), Che and Hausch (1999), and Segal and Whinston (2002) have shown that there are no contractual arrangements that induce efficient investments in the presence of direct externalities, provided that the parties cannot commit not to exploit future gains from trade and each party receives a positive fraction of the renegotiation surplus. In the absence of direct externalities, the parties can solve the hold-up problem by writing appropriate contracts, as has been demonstrated by Edlin and Reichelstein (1996).⁹ Hence, the standard argument that it is the presence of externalities which calls for intervention by the government is true in the present context. Moreover, the fact that in accordance with the Coase Theorem the parties will always exhaust any ex post gains from trade does not *solve* the hold-up problem, instead it *causes* the hold-up problem. In this sense, our paper indeed shows that the very Coase Theorem can justify government interventions that are usually associated with Pigou.

The remainder of the paper is organized as follows. In section 2, we show that our argument outlined above can be generalized to a framework with uncertainty where effort and valuation are continuous variables. In section 3, we discuss heterogeneous bargaining powers, the role of further costs of the producer, and two-sided investments. While it may no longer achieve the first best, it turns out that our simple taxation scheme can still implement significant welfare improvements. Concluding remarks follow in section 4. Finally, some technical details have been relegated to the appendix.

⁹See also Rogerson (1992) and Hermalin and Katz (1993), who show that the first best can be achieved if the parties can commit not to exploit future gains from trade, even in the presence of private information. Schmitz (2002a) shows that their results can be extended to the case in which renegotiation is possible, provided that there are no direct externalities. In general, the first best cannot be attained in the presence of private information and direct externalities (see Schmitz, 2002b). For the case of symmetric information, see also Aghion, Dewatripont, and Rey (1994), Chung (1991), Nöldeke and Schmidt (1995), and De Fraja (1999), who derive first best results for alternative forms of renegotiation.

2 The model

Consider two risk-neutral parties, a producer A and a buyer B . At date 0, the parties can write a contract. At date 1, the producer chooses an unobservable relationship-specific effort level $e \geq 0$. Her personal effort costs are given by the increasing and convex function $c(e)$, which satisfies the usual Inada conditions $c'(0) = 0$ and $\lim_{e \rightarrow \infty} c'(e) = \infty$. At date 2, the buyer's gains from trade $v \geq 0$, which stochastically depend on e , are realized.¹⁰ At date 3, trade can occur and payments can be made. If the contract does not already lead to trade, the parties will negotiate according to the generalized Nash bargaining solution, where the producer's bargaining power is given by $\alpha \in (0, 1)$.

The buyer's valuation $v \in [v_l, v_h]$ is observable by the two parties, but unverifiable to outsiders. Let the buyer's valuation be distributed according to the cumulative distribution function $F(v|e)$. We assume that the producer's effort increases the buyer's valuation in the sense of first-order stochastic dominance, so that $F_e(v|e) < 0$. Moreover, we assume that $F_{ee}(v|e) > 0$, so that the expected value $E[v|e]$ is concave in e . The probability of trade is denoted by $x \in [0, 1]$. In a first-best world, trade would always occur ($x^{FB} = 1$), and the effort level would be $e = e^{FB}$, where

$$e^{FB} = \arg \max E[v|e] - c(e) \quad (1)$$

maximizes the expected social surplus. We say that the hold-up problem is solved if the parties are induced to make these first-best decisions.

Let $t \in (0, 1)$ denote the tax rate and suppose that the buyer must pay $t \cdot (\bar{v} - z)$ to the government; i.e., any payment z that he makes to the producer is deductible. The tax base \bar{v} can be an arbitrary constant (see the discussion at the end of this

¹⁰One can imagine that the producer's effort influences the quality of the specific good to be traded, which also depends on random events. In this section we assume that the good has only value for the buyer and the producer incurs no further (opportunity) costs at date 3.

section). Hence, the parties' payoffs are as follows:

$$\begin{aligned} u_A &= z - c(e) \\ u_B &= xv - t\bar{v} - (1-t)z \end{aligned}$$

In general, a contract between the two parties can specify a trade decision and a transfer payment as a function of verifiable messages sent after the state of the world has been realized.¹¹ Thus, a contract is given by $[X(s_A, s_B), Z(s_A, s_B)]$, where s_A and s_B denote A 's and B 's reporting strategies, that can depend on the true valuation v . It is straightforward to see that the parties would write a contract solving the hold-up problem if ex post negotiations were impossible.¹² However, as we have discussed in the introduction, a contract may be valueless when we take into consideration that the parties will always exploit any remaining gains from trade through Coasean bargaining. Since ex post efficiency ($x = 1$) is thus achieved independently of any ex ante contract, the only use of such a contract could be to improve effort incentives.

Proposition 1 *a) Let \tilde{e} denote the effort level that the producer chooses in the absence of an ex ante contract. Then an effort level \hat{e} can be contractually induced if and only if $\hat{e} \in [0, \tilde{e}]$.*

b) The parties write no contract at date 0, i.e. $[X, Z] \equiv [0, 0]$.

c) The producer chooses the effort level $\tilde{e} = \arg \max E \left[\frac{\alpha}{1-t} v | e \right] - c(e)$.

Proof. See the appendix. ■

¹¹An example for such a contract is the option contract mentioned in the introduction. In the case of the option contract, only the buyer sends a message (namely, whether or not he exercises the option).

¹²For example, consider the following contract. After v has been realized, the seller and the buyer both report a value. If the reports match, trade occurs, and the buyer pays the reported value. Otherwise, no trade occurs. It is an equilibrium that both parties tell the truth and the seller invests e^{FB} . More sophisticated mechanisms in order to get rid of inefficient equilibria can easily be constructed following Moore (1992).

Intuitively, in the absence of a contract the producer will receive a fraction of the buyer's realized valuation through Coasean bargaining at date 3. Thus, she has at least some incentive to exert effort at date 1 in order to increase the buyer's valuation. On the other hand, if the contract simply prescribed trade at an ex ante specified price, ex post efficiency would be achieved without further bargaining at date 3, but the producer had no incentives to exert effort, because this would only benefit the buyer. The proof of Proposition 1a) shows that even more sophisticated contracts can only reduce the incentives to exert effort when ex post inefficiencies are always negotiated away at date 3. This result is in the spirit of Che and Hausch (1999) and Segal and Whinston (2002) who argue that parties cannot solve the hold-up problem by writing contracts, because this could only decrease effort further below the first-best level. Yet, our model differs from their models (which do not consider taxation), because here utility is not transferable on a 1:1 basis from one party to the other party.¹³ In particular, in our framework the no-contract effort level \tilde{e} may well be *above* the first-best level e^{FB} .¹⁴ In this case, the parties *could* in principle write a contract inducing $e = e^{FB}$. However, Proposition 1b) says that such a contract can never be profitable for both parties simultaneously and thus will never be written.

Specifically, assume that the parties write no ex ante contract, so that trade will only occur through ex post bargaining. Since $[X, Z] \equiv [0, 0]$, party A 's and party B 's threatpoint payoffs at date 3 (i.e., after the effort costs $c(e)$ are sunk) are given by 0 and $-t\bar{v}$, respectively. Thus, the payment according to the generalized Nash bargaining solution is characterized by

$$z = \arg \max z^\alpha (v - (1 - t)z)^{1-\alpha},$$

¹³In general, the irrelevance of contracting might no longer hold if utilities are non-transferable; see Bensaid and Gary-Bobo (1993) for a related point in a different setting.

¹⁴It should be noted that overinvestments are also possible in the model of Muthoo (1998), yet for different reasons (his focus is on the communication technology in outside option bargaining).

i.e. by $z = \frac{\alpha}{1-t}v$. The expected payoff of the producer at date 1 is hence given by

$$E \left[\frac{\alpha}{1-t}v | e \right] - c(e). \quad (2)$$

The first-best effort level can be induced by an appropriate tax rate, as is stated in the following result.

Corollary 1 *The government can solve the hold-up problem by choosing the tax rate $t = 1 - \alpha$.*

Proof. This follows immediately from the fact that trade always occurs, i.e. ex post efficiency is achieved through negotiations at date 3, and the producer chooses e in order to maximize (2), which coincides with the definition of e^{FB} given in (1) if $\frac{\alpha}{1-t} = 1$. ■

In contrast, \tilde{e} is smaller (larger) than e^{FB} whenever the tax rate t is smaller (larger) than $1 - \alpha$. A strictly positive tax rate is thus necessary in order to solve the hold-up problem whenever the buyer has some bargaining power.¹⁵ While we follow the literature in assuming that the parties' bargaining powers cannot be changed, the government can influence the bargaining outcome (and hence the investment incentives) by taxation, the important effect of which is to change the slope of the Pareto frontier that is the boundary of the parties' feasible payoff pairs at date 3.

Note that the result that in the absence of an ex ante contract the first best will be achieved in case of $t = 1 - \alpha$ does not depend on the particular way in which the producer's effort level influences the buyer's valuation.¹⁶

Finally, it should also be noted that it is not important for our result how the tax base \bar{v} is chosen, as long as it is exogenously given, because obviously it has no influence on the incentives. For example, the government could set $\bar{v} = E[v|e^{FB}]$, so

¹⁵Of course, if the producer had all bargaining power ($\alpha = 1$), the first best would be achieved without taxation, since there would be no hold-up problem in the first place.

¹⁶For example, the producer's effort could be a multidimensional variable. What is important is that the right hand side of (1) coincides with (2) for $t = 1 - \alpha$.

that the expected tax revenue would be zero in equilibrium. What is important for the incentives is the fact that the buyer can deduct his payment to the producer from his tax base (i.e., there is a tax subsidy). We might also set $\bar{v} = 0$, so that tz would simply be a subsidy,¹⁷ if the government can use other funds to finance the subsidy. For example, it might impose a lump sum tax on the seller, such that in equilibrium the expected tax revenue is zero. However, it should be mentioned that we cannot impose government budget balance off the equilibrium path (provided there are no third parties who could be taxed), because then the subsidy to the buyer would no longer be financed by a lump sum tax. Rational parties would “see through” the budget constraint and thus we would have neutrality of the tax-subsidy scheme.¹⁸

3 Discussion

3.1 Bargaining powers

It is a standard assumption in the literature on the hold-up problem to model negotiations with the regular Nash bargaining solution, i.e. with $\alpha = \frac{1}{2}$.¹⁹ In this case, the solution to the hold-up problem given in section 2 is remarkably simple to implement. A tax rate of 50% is sufficient, independent of the characteristics of the particular hold-up problem under consideration, such as the effort cost function or the distribution function of the valuations. However, if the parties’ bargaining powers differ, the solution offered in the previous section only implements the first best if $t = 1 - \alpha$. One might argue that the government does not know the precise bargaining powers of any two parties that are in the hold-up dilemma. Moreover, one might (not just

¹⁷In this case, the buyer would neither pay a tax nor receive a subsidy if the parties did not agree on trade (of course, this never happens in equilibrium).

¹⁸To see this point formally, set $\tau = t$ in equation (3) in section 3.3 below. We would like to thank an anonymous referee for pointing out this instance of Ricardian equivalence.

¹⁹See e.g. Hart (1995), Aghion and Tirole (1994), Hart, Shleifer, and Vishny (1997), Tirole (1999), or Roider (2004).

in our model, but quite generally) doubt whether a tax system can be sufficiently fine-tuned in order to solve specific externality problems when there are heterogeneous parties facing such problems. Therefore, it might be interesting to observe that even if the government only knows the distribution of the bargaining powers and cannot fine-tune the tax rate, a significant welfare improvement can be achieved by simply using a rule-of-thumb tax scheme.

Specifically, suppose that the bargaining power α is uniformly distributed on the unit interval, but the government can only set one tax rate t independent of α . For simplicity, assume that there is a deterministic relationship between the producer's effort and the buyer's valuation, $v = \sqrt{e}$. Moreover, let $c(e) = e$, so that the total surplus generated by the parties is $\sqrt{e} - e$. Given tax rate t , the producer chooses $\tilde{e} = \arg \max \frac{\alpha}{1-t} \sqrt{e} - e$. Hence, $\tilde{e} = \frac{\alpha^2}{(2-2t)^2}$ and the expected total surplus is $\int_0^1 \left(\frac{\alpha}{2-2t} - \frac{\alpha^2}{(2-2t)^2} \right) d\alpha = \frac{1}{12} \frac{2-3t}{(1-t)^2}$, which is maximized by $t = \frac{1}{3}$. The resulting surplus is $\frac{3}{16}$, while the first best surplus is $\frac{1}{4}$ and the second best surplus without taxation is $\frac{1}{6}$. In other words, in this example even an easily implementable rule-of-thumb tax scheme would lead to a realization of 75% of the first best surplus, while in the absence of taxation only 66% would be realized due to the hold-up problem.

3.2 Further costs

In section 2 we considered a model in which trade was always efficient. While this is done in many contributions to the literature on the hold-up problem,²⁰ one can also consider the additional problem that arises when trade is only ex post efficient in some states of the world. Therefore, let us now assume that the producer incurs further costs k if and only if she trades with the buyer, so that the payoffs are given

²⁰See e.g. Rubinstein and Wolinsky (1992), Aghion and Tirole (1994), Hart (1995), Hart, Shleifer, and Vishny (1997), Nöldeke and Schmidt (1998), Tirole (1999), or Gul (2001).

by

$$\begin{aligned} u_A &= z - xk - c(e), \\ u_B &= xv - t\bar{v} - (1 - t)z. \end{aligned}$$

Now trade is efficient whenever $v - k \geq 0$, and the first best effort level is characterized by

$$e^{FB} = \arg \max E[\max\{v - k, 0\}|e] - c(e).$$

For simplicity, assume that the parties negotiate ex post according to the regular Nash bargaining solution. The Nash product $(z - xk)(xv - (1 - t)z)$ is now maximized by $z = x \frac{v + (1 - t)k}{2(1 - t)}$, so that the parties choose $x = 1$ whenever $v - (1 - t)k \geq 0$. Hence, setting $t > 0$ means that the parties will want to trade too often at date 3. If there is no uncertainty, so that the buyer's valuation depends deterministically on the producer's effort by a function $v = \check{v}(e)$, this is no problem. In this case, the government could simply set $t = \frac{1}{2}$ if $\check{v}(e^{FB}) \geq k$, and $t = 0$ otherwise.²¹ However, in the presence of uncertainty there is now a trade-off between improving the producer's investment incentives and inducing the ex post efficient trade decision. The producer chooses

$$\tilde{e} = \arg \max E \left[\max \left\{ \frac{v}{2(1 - t)} - \frac{k}{2}, 0 \right\} | e \right] - c(e),$$

so that in general the first best will not be achieved. Yet, Pigouvian taxation can still generate significant welfare improvements.

As an illustration, let $e \in \{0, 1\}$ and let v be distributed on the unit interval according to the distribution function

$$F(v) = \begin{cases} v & \text{if } e = 0, \\ v^2 & \text{if } e = 1. \end{cases}$$

Assume that $c(0) = 0$, $c(1) = \frac{1}{20}$, and $k = \frac{1}{2}$. It is easy to check that the first best surplus is given by $\int_{1/2}^1 (v - \frac{1}{2}) 2v dv - \frac{1}{20} \approx .158$. The producer's payoff is

²¹Notice that the government can calculate $\check{v}(e^{FB})$, even though it cannot observe the actually chosen effort e and thus $\check{v}(e)$.

$\int_{(1-t)/2}^1 \left(\frac{v}{2(1-t)} - \frac{1}{4} \right) 2v dv - \frac{1}{20}$ if she exerts effort, and $\int_{(1-t)/2}^1 \left(\frac{v}{2(1-t)} - \frac{1}{4} \right) dv$ otherwise. Straightforward calculations show that the smallest tax rate which induces the producer to exert effort is given by $t \approx .074$. If the government sets this tax rate, the total surplus is $\int_{(1-t)/2}^1 \left(v - \frac{1}{2} \right) 2v dv - \frac{1}{20} \approx .157$, while it would be .125 without taxation. Thus, without taxation less than 79% of the expected first-best surplus could be realized, while more than 99% are realized with taxation.

3.3 Two-sided investments

Finally, let us discuss an extension of the basic model in which both parties can undertake cooperative investments that can enhance the gains from trade. In the previous subsection, we assumed that the producer's costs k which are incurred whenever trade takes place were exogenously given. However, it might also be the case that the buyer can exert effort in order to reduce these costs. Therefore, let the parties' payoffs now be given by

$$\begin{aligned} u_A &= (1 - \tau)z - xk - c_A(e_A), \\ u_B &= xv - t\bar{v} - (1 - t)z - c_B(e_B), \end{aligned}$$

where e_i denotes party i 's effort, c_i is party i 's cost function, and the producer pays a tax τz .²² The valuation $v \in [v_l, v_h]$ is still distributed according to the distribution function $F(v|e_A)$, while the costs $k \in [k_l, k_h]$ are distributed according to a distribution function $G(k|e_B)$. The first-best outcome is again characterized by $x^{FB} = 1$ whenever $v - k \geq 0$ and the first-best effort levels are given by $e_A^{FB} = \arg \max E[\max\{v - k, 0\}|e_A, e_B^{FB}] - c_A(e_A)$ and $e_B^{FB} = \arg \max E[\max\{v - k, 0\}|e_A^{FB}, e_B] - c_B(e_B)$.

For simplicity, assume again that the parties negotiate ex post according to the regular Nash bargaining solution. The Nash product $((1 - \tau)z - xk)(xv - (1 - t)z)$

²²In analogy to the discussion at the end of section 2, the producer's tax could be given back as a lump sum payment T , such that in equilibrium the tax revenue is zero. Since a constant payment does not alter the incentives, for simplicity we do not introduce the additional notation here. In the following discussion, the total surplus includes the tax revenue.

is now maximized by $z = x \frac{v(1-\tau)+k(1-t)}{2(1-t)(1-\tau)}$ and the parties choose $x = 1$ whenever $(1-\tau)v - (1-t)k \geq 0$. The parties' effort levels are thus given by

$$\begin{aligned}\tilde{e}_A &= \arg \max E \left[\max \left\{ \frac{(1-\tau)v}{2(1-t)} - \frac{k}{2}, 0 \right\} | e_A, \tilde{e}_B \right] - c_A(e_A), \\ \tilde{e}_B &= \arg \max E \left[\max \left\{ \frac{v}{2} - \frac{(1-t)k}{2(1-\tau)}, 0 \right\} | \tilde{e}_A, e_B \right] - c_B(e_B).\end{aligned}\tag{3}$$

In general, there is now an additional trade-off between improving party B 's investment incentives (i.e., making τ larger than t) and improving party A 's investment incentives. With regard to this trade-off, whether or not τ should be larger than t depends on the relative importance of the parties' investment decisions.²³

As an illustration, assume again simple deterministic technologies, where $v = 4 + e_A$, $k = 4 - e_B$, $c_A(e_A) = e_A^2$, and $c_B(e_B) = \frac{1}{8}e_B^2$. The first-best surplus is $9/4$, where $e_A^{FB} = 1/2$ and $e_B^{FB} = 4$. Given tax rates t and τ , the producer's effort is now $\tilde{e}_A = \frac{1}{4} \frac{1-\tau}{1-t}$, while the buyer's effort is $\tilde{e}_B = 2 \frac{1-t}{1-\tau}$. In the absence of taxation, the surplus thus is $27/16$. In contrast, if $\tau = .49$ and $t = 0$ (since here the buyer's investment is more important), the surplus is 2.11 . In other words, without taxation only 75% of the first-best surplus would be realized due to the hold-up problem, while more than 93% can be realized with taxation.

4 Conclusion

It is true that externalities *per se* do not automatically make intervention by the government through Pigouvian taxation necessary in order to maximize the social surplus. If the activities that have external effects are verifiable, the parties can negotiate contracts which induce an internalization of the externalities, as is suggested by the Coase Theorem. But if investments with direct externalities are unverifiable, contractual arrangements may have no value. Indeed, the very reason that contracts

²³Note that there is an analogy to the incomplete contracting literature, where hold-up problems can be mitigated by assigning ownership rights (see Hart, 1995). In this literature, who should be the owner depends on whose investment decisions are relatively more important.

fail to induce first-best behavior is the fact that (after the investments have been sunk) private parties will always exhaust all ex post gains from trade through Coasean bargaining. A simple form of Pigouvian taxation can solve or at least alleviate the resulting hold-up problem.

Our analysis illustrates that removing tax subsidies, which is a prominent item on the political agenda of many European countries, may well have negative welfare consequences, because it might aggravate hold-up problems. More generally, our paper emphasizes that if hold-up problems do have the importance that is suggested by recent contributions in the contract theoretic literature, then the possibility to reduce the welfare losses caused by hold-up problems with the help of government intervention should not be completely neglected.

Appendix

Proof of Proposition 1.

Suppose that the parties have written a contract $[X(s_A, s_B), Z(s_A, s_B)]$ at date 0. At date 3, after the parties A and B have chosen their strategies s_A and s_B , respectively, the parties will negotiate in order to exploit the remaining gains from trade whenever $X(s_A, s_B) < 1$. According to the generalized Nash bargaining solution, the outcome of the negotiations can be characterized by maximizing the Nash product

$$(\zeta - Z(s_A, s_B))^\alpha ((1 - X(s_A, s_B))v - (1 - t)(\zeta - Z(s_A, s_B)))^{1-\alpha},$$

where we have used the fact that the parties' threatpoint payoffs are given by $Z(s_A, s_B)$ and $X(s_A, s_B)v - (1 - t)Z(s_A, s_B) - t\bar{v}$, respectively. Hence, the payment that the producer ultimately receives is given by $\zeta = Z(s_A, s_B) + \frac{1-X(s_A, s_B)}{1-t}\alpha v$. The parties' date 3 payoffs are thus given by

$$\omega_A(s_A, s_B, v) = Z(s_A, s_B) + \frac{1 - X(s_A, s_B)}{1 - t}\alpha v, \quad (4)$$

$$\begin{aligned} \omega_B(s_A, s_B, v) &= v - (1 - t)Z(s_A, s_B) - t\bar{v} - (1 - X(s_A, s_B))\alpha v \\ &= v - t\bar{v} - (1 - t)\omega_A(s_A, s_B, v). \end{aligned} \quad (5)$$

In equilibrium, the producer will choose $s_A(v)$ such that for all $(v, \tilde{v}) \in [v_l, v_h]^2$

$$\omega_A(s_A(v), s_B(v), v) \geq \omega_A(s_A(\tilde{v}), s_B(v), v),$$

and the buyer will analogously choose $s_B(v)$ such that for all $(v, \tilde{v}) \in [v_l, v_h]^2$

$$v - t\bar{v} - (1 - t)\omega_A(s_A(v), s_B(v), v) \geq v - t\bar{v} - (1 - t)\omega_A(s_A(v), s_B(\tilde{v}), v),$$

which is equivalent to

$$\omega_A(s_A(v), s_B(\tilde{v}), v) \geq \omega_A(s_A(v), s_B(v), v).$$

Hence, we must have

$$\omega_A(s_A(\tilde{v}), s_B(v), v) \leq \omega_A(s_A(v), s_B(v), v) \leq \omega_A(s_A(v), s_B(\tilde{v}), v) \quad (6)$$

if v is the buyer's true valuation, and analogously

$$\omega_A(s_A(v), s_B(\tilde{v}), \tilde{v}) \leq \omega_A(s_A(\tilde{v}), s_B(\tilde{v}), \tilde{v}) \leq \omega_A(s_A(\tilde{v}), s_B(v), \tilde{v}) \quad (7)$$

if \tilde{v} is the buyer's true valuation. The two chains of inequalities (6) and (7) imply together with (4) and (5) that

$$\begin{aligned} & \frac{\alpha}{1-t} (1 - X(s_A(v), s_B(\tilde{v}))) (\tilde{v} - v) \\ &= \omega_A(s_A(v), s_B(\tilde{v}), \tilde{v}) - \omega_A(s_A(v), s_B(\tilde{v}), v) \\ &\leq \omega_A(s_A(\tilde{v}), s_B(\tilde{v}), \tilde{v}) - \omega_A(s_A(v), s_B(v), v) \\ &\leq \omega_A(s_A(\tilde{v}), s_B(v), \tilde{v}) - \omega_A(s_A(\tilde{v}), s_B(v), v) \\ &= \frac{\alpha}{1-t} (1 - X(s_A(\tilde{v}), s_B(v))) (\tilde{v} - v). \end{aligned}$$

Thus, dividing by $(\tilde{v} - v)$ and letting \tilde{v} converge to v , we obtain

$$\frac{d\omega_A(s_A(v), s_B(v), v)}{dv} = \frac{\alpha}{1-t} (1 - X(s_A(v), s_B(v))) \quad (8)$$

almost everywhere. Now consider the producer's incentives to exert effort at date 1.

Her marginal revenue from exerting effort is

$$\begin{aligned} & \frac{dE[\omega_A(s_A(v), s_B(v), v)|e]}{de} \\ &= \frac{d}{de} \left[\omega_A(s_A(v_h), s_B(v_h), v_h) - \int_{v_l}^{v_h} \frac{d\omega_A(s_A(v), s_B(v), v)}{dv} F(v|e) dv \right] \\ &= - \int_{v_l}^{v_h} \frac{d\omega_A(s_A(v), s_B(v), v)}{dv} F_e(v|e) dv \\ &= - \int_{v_l}^{v_h} \frac{\alpha}{1-t} (1 - X(s_A(v), s_B(v))) F_e(v|e) dv, \end{aligned}$$

where the second line follows from integration by parts and the last line follows from (8).

Given the contract $[X(s_A, s_B), Z(s_A, s_B)]$, the producer will hence choose $e = \hat{e}$, which is uniquely determined by

$$- \int_{v_l}^{v_h} \frac{\alpha}{1-t} (1 - X(s_A(v), s_B(v))) F_e(v|\hat{e}) dv = c'(\hat{e}).$$

Note that $\hat{e} = 0$ if $X \equiv 1$. The no-contract effort level is given by

$$-\int_{v_l}^{v_h} \frac{\alpha}{1-t} F_e(v|\tilde{e}) dv = c'(\tilde{e}).$$

It is straightforward to see that any $X \neq 0$ can only make \hat{e} smaller than \tilde{e} . Moreover, any effort level $e \in [0, \tilde{e}]$ can obviously be induced by a contract that specifies a suitable fixed trade level $X \in [0, 1]$, which completes the proof of part a).

Consider a contract $[X(s_A, s_B), Z(s_A, s_B)]$ that induces investment \hat{e} and let $\hat{x}(v) \equiv X(s_A(v), s_B(v))$, $\hat{z}(v) \equiv Z(s_A(v), s_B(v))$. The parties will agree on such a contract whenever there exists a z_0 such that the producer can be made better off,

$$E \left[\hat{z}(v) + \frac{1 - \hat{x}(v)}{1-t} \alpha v | \hat{e} \right] - c(\hat{e}) + z_0 \geq E \left[\frac{\alpha}{1-t} v | \tilde{e} \right] - c(\tilde{e}),$$

and simultaneously the buyer can be made better off,

$$E[v - t\bar{v} - (1-t)\hat{z}(v) - (1 - \hat{x}(v))\alpha v | \hat{e}] - (1-t)z_0 \geq E[(1-\alpha)v - t\bar{v} | \tilde{e}].$$

Such a z_0 exists if and only if

$$\begin{aligned} & E \left[\frac{\alpha}{1-t} v | \tilde{e} \right] - c(\tilde{e}) - E \left[\hat{z}(v) + \frac{1 - \hat{x}(v)}{1-t} \alpha v | \hat{e} \right] + c(\hat{e}) \\ & \leq \frac{1}{1-t} (E[v - t\bar{v} - (1-t)\hat{z}(v) - (1 - \hat{x}(v))\alpha v | \hat{e}] - E[(1-\alpha)v - t\bar{v} | \tilde{e}]) \end{aligned}$$

which is equivalent to

$$E \left[\frac{1}{1-t} v | \tilde{e} \right] - c(\tilde{e}) \leq E \left[\frac{1}{1-t} v | \hat{e} \right] - c(\hat{e}). \quad (9)$$

Let $\check{e} = \arg \max E \left[\frac{1}{1-t} v | e \right] - c(e)$. Note that $\tilde{e} < \check{e}$ due to $\alpha < 1$ and concavity. Moreover, we know from part a) that for any contract we have $\hat{e} \leq \tilde{e}$. Hence, there exists no contract so that (9) holds with strict inequality, which proves part b) of the proposition. Part c) then follows immediately. With regard to the discussion following the proposition, note that the marginal revenue from exerting effort in the first-best solution is given by

$$\frac{dE[v|e]}{de} = \frac{d}{de} \left[v_h - \int_{v_l}^{v_h} F(v|e) dv \right] = - \int_{v_l}^{v_h} F_e(v|e) dv,$$

so that the first-best effort level is determined by

$$-\int_{v_l}^{v_h} F_e(v|e^{FB})dv = c'(e^{FB}).$$

Hence, \tilde{e} is smaller (larger) than e^{FB} whenever $\frac{\alpha}{1-t}$ is smaller (larger) than 1. ■

References

- AGHION, P., DEWATRIPONT, M. and REY, P. (1994). Renegotiation design with unverifiable information. *Econometrica*, **62**, 257–282.
- AGHION, P. and TIROLE, J. (1994). The management of innovation. *Quarterly Journal of Economics*, **109**, 1185–1209.
- BENSAID, B. and GARY-BOBO, R.J. (1993). Commitment value of contracts under renegotiation constraints. *Econometrica*, **61**, 1423–1429.
- CHE, Y.-K. and HAUSCH, D.B. (1999). Cooperative investments and the value of contracting. *American Economic Review*, **89**, 125–147.
- CHUNG, T.-Y. (1991). Incomplete contracts, specific investments, and risk sharing. *Review of Economic Studies*, **58**, 1031–1042.
- COASE, R. (1960). The problem of social cost. *Journal of Law and Economics*, **1**, 1–44.
- DE FRAJA, G. (1999). After you sir. Hold-up, direct externalities, and sequential investment. *Games and Economic Behavior*, **26**, 22–39.
- EDLIN, A.S. and REICHELSTEIN, S. (1996). Holdups, standard breach remedies and optimal investment. *American Economic Review*, **86**, 478–501.
- GUL, F. (2001). Unobservable investment and the hold-up problem. *Econometrica*, **69**, 343–376.
- HART, O.D. (1995). *Firms, Contracts and Financial Structure*, Oxford: Clarendon Press.
- HART, O., SHLEIFER, A. and VISHNY, R.W. (1997). The proper scope of government: Theory and application to prisons. *Quarterly Journal of Economics*, **112**, 1127–1161.

- HERMALIN, B.E. and KATZ, M.L. (1993). Judicial modifications of contracts between sophisticated parties: A more complete view of incomplete contracts and their breach. *Journal of Law, Economics, and Organization*, **9**, 230–255.
- MAS-COLELL, A., WHINSTON, M.D. and GREEN, J.R. (1995). *Microeconomic Theory*. New York, Oxford: Oxford University Press.
- MASKIN, E. and MOORE, J. (1999). Implementation and renegotiation. *Review of Economic Studies*, **66**, 39–56.
- MOORE, J. (1992). Implementation, contracts, and renegotiation in environments with complete information, in: Laffont, J.-J. (ed.), *Advances in Economic Theory*, Cambridge, University Press, 182–282.
- MUTHOO, A. (1990). Bargaining without commitment. *Games and Economic Behavior*, **2**, 291–297.
- MUTHOO, A. (1998). Sunk costs and the inefficiency of relationship-specific investments. *Economica*, **65**, 97–106.
- MUTHOO, A. (1999). *Bargaining Theory with Applications*. Cambridge, U.K.: Cambridge University Press.
- MYERSON, R.B. and SATTERTHWAITE, M.A. (1983). Efficient mechanisms for bilateral trading. *Journal of Economic Theory*, **29**, 265–281.
- NÖLDEKE, G. and SCHMIDT, K.M. (1995). Option contracts and renegotiation: A solution to the hold-up problem. *Rand Journal of Economics*, **26**, 163–179.
- NÖLDEKE, G. and SCHMIDT, K.M. (1998). Sequential investments and options to own. *Rand Journal of Economics*, **29**, 633–653.
- PIGOU, A.C. (1932). *The Economics of Welfare*. London: Macmillan.
- ROGERSON, W.P. (1992). Contractual solutions to the hold-up problem. *Review of Economic Studies*, **59**, 774–794.

- ROIDER, A. (2004). Asset ownership and contractibility of interaction. *Rand Journal of Economics*, **35**, 787–802.
- RUBINSTEIN, A. and WOLINSKY, A. (1992). Renegotiation-proof implementation and time preferences. *American Economic Review*, **82**, 600–614.
- SCHMITZ, P.W. (2001). The hold-up problem and incomplete contracts: A survey of recent topics in contract theory. *Bulletin of Economic Research*, **53**, 1–17.
- SCHMITZ, P.W. (2002A). Simple contracts, renegotiation under asymmetric information, and the hold-up problem. *European Economic Review*, **46**, 169–188.
- SCHMITZ, P.W. (2002B). On the interplay of hidden action and hidden information in simple bilateral trading problems. *Journal of Economic Theory*, **103**, 444–460.
- SCHMITZ, P.W. (2006). Information gathering, transaction costs, and the property rights approach. *American Economic Review*, **96**, 422–434.
- SEGAL, I. and WHINSTON, M.D. (2002). The Mirrlees approach to mechanism design with renegotiation (with applications to hold-up and risk-sharing). *Econometrica*, **70**, 1–45.
- TIROLE, J. (1999). Incomplete contracts: Where do we stand? *Econometrica*, **67**, 741–781.
- WILLIAMSON, O.E. (2000). The new institutional economics: Taking stock, looking ahead. *Journal of Economic Literature*, **38**, 595–613.
- WILLIAMSON, O.E. (2002). The theory of the firm as governance structure: From choice to contract. *Journal of Economic Perspectives*, **16**, 171–95.