Pollution Claim Settlements Reconsidered: Hidden Information and Bounded Payments

Susanne Goldlücke, Patrick W. Schmitz

PII: S0014-2921(18)30146-6
DOI: https://doi.org/10.1016/j.euroecorev.2018.08.005
Reference: EER 3177

To appear in: *European Economic Review*

Received date: 19 March 2018
Accepted date: 16 August 2018

Pollution Claim Settlements Reconsidered: Hidden Information and Bounded Payments*

Susanne Goldlücke[a] and Patrick W. Schmitz[b]

[a] *University of Konstanz, Germany, and CEPR, London, UK*
[b] *University of Cologne, Germany, and CEPR, London, UK*

Abstract

A principal's production decision imposes a negative externality on an agent. The principal may be a pollution-generating firm, the agent may be a nearby town. The principal offers a contract to the agent, who has the right to be free of pollution. Then the agent privately learns the disutility of pollution. Finally, a production level and a transfer payment are implemented. Suppose there is an upper bound (possibly zero) on payments that the agent can make to the principal. In the second-best solution, there is underproduction for low cost types, while there is overproduction for high cost types. In contrast to standard adverse selection models of pollution claim settlements, there may thus be *too much* pollution compared to the first-best solution.

Keywords: Coasian contracting; negative externalities; hidden information; limited liability; overproduction

JEL Classification: D86; D82; D23; D62; H23

---

* Susanne Goldlücke: Department of Economics, University of Konstanz, Box 150, 78457 Konstanz, Germany. E-mail address: <susanne.goldluecke@uni-konstanz.de>. Patrick Schmitz: Department of Economics, University of Cologne, Albertus-Magnus-Platz, 50923 Köln, Germany. E-mail address: <patrick.schmitz@uni-koeln.de>. We would like to thank an associate editor and three referees for making valuable comments and suggestions. We also thank Oliver Gürtler, Eva Hoppe, Daniel Krähmer, and Daniel Müller for helpful discussions. Patrick Schmitz gratefully acknowledges financial support under the Institutional Strategy of the University of Cologne within the German Excellence Initiative (Hans-Kelsen-Prize 2015).