

Price-setting power vs. private information: An experimental evaluation of their impact on holdup

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Abstract

This paper investigates the extent of the holdup problem in a buyer–seller relationship in which the seller has private information about his alternative opportunities. Theory predicts that, compared to a situation in which outside options are publicly observed, the seller obtains an informational rent whereas the buyer bears an informational loss. As a result the seller is predicted to invest more while the buyer is expected to invest less. In contrast to this, private information has no impact on the investment levels observed in the experiment. But actual investments do increase with the price-setting power of the investor. These findings are roughly consistent with a model in which agents are inequality-averse. Overall the results question some recent theoretical suggestions that private information rents might substitute for price-setting power in mitigating holdup.

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1. Introduction

When a party makes a relationship-specific investment, this investment is at risk because the other party may force a renegotiation of the deal. Anticipating that she may be unable to reap the full return, the investor will invest less than the efficient level. This is the well-known holdup underinvestment problem. This problem is considered to be of central

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importance in a wide variety of economic contexts (cf. Klein et al., 1978; Williamson, 1985). For example, it serves as the cornerstone of the property rights theory of the firm; see Hart (1995) for an overview.

Most existing theoretical work analyses the holdup problem under the assumption of symmetric information. This carries over to the experimental studies in the field. In reality, however, the contracting parties usually possess some private information, and this may have important implications for holdup. Malcomson (1999, p. 2333) for instance notes that:

...in some cases at least, a firm will not know the value of the employee's outside option $\omega(s)$, if only because it does not know how much the employee enjoys this job relative to others. Similarly, an employee may not know the value of the firm's outside option $\pi(I, s)$. Little is known about hold-up and renegotiation under these circumstances.

Intuitively the impact of private information on holdup seems rather clear. Private information yields the informed party an informational rent, while the uninformed party bears an informational loss. This boosts the investment incentives of the informed party and weakens those of the uninformed party. Some theoretical contributions indeed indicate that holdup is less severe when the investor is better informed. Gul (2001), for example, shows that the holdup problem disappears when the investor is privately informed about the actual investment made (and only the non-investor makes frequently repeated offers).¹ In his model the creation of private information rents induces efficient investment incentives. The exploratory analysis in Malcomson (1997) suggests that similar results are to be expected when the investor has private information about its outside options (rather than about the investment made). This paper studies such a situation in more detail. In particular, we consider a simple model in which a seller may have private information about his outside options. We first show that theoretically the private information rent he so obtains typically boosts his investment incentives. The downside is that the buyer, who now has an informational disadvantage, then has less incentives to invest.

Standard theory thus predicts that investment incentives under private information are quite different from those under public information. It also indicates that private information itself can serve as an effective instrument against holdup. One objective of Gul (2001, p. 344), for example, is

...to emphasize the role of allocation of information as a tool in dealing with the hold-up problem. Audits, disclosure rules or privacy rights could be used to optimize the allocation of rents and guarantee the desired level of investment. Controlling the flow of information may prove to be a worthy alternative to controlling bargaining power in designing optimal organizations.

Rogerson (1992), Lau (2002) and Gonzalez (2004) similarly suggest that private information rents might substitute for bargaining power in mitigating holdup. Our theoretical analysis yields the same result for a situation with private information about

¹See also Konrad (2001), Lau (2002) and Tirole (1986) for settings in which the specific investment itself is private information.

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