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Menus of price-quantity contracts for inducing the truth in environmental regulation

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ABSTRACT

Many authors have proposed mechanisms to induce regulated polluting firms to truthfully reveal their private information. This paper proposes an alternative scheme in which the regulator offers each firm a menu of linear price-quantity contracts; faced with this menu, each firm's dominant strategy is to truthfully report its private information and self-select the contract that is ex post efficient. The proposed menu schedule that is more elastic than the firm's residual marginal damage function engenders a positive quantity effect, thereby counterbalancing the firm's incentive to misreport prompted by the linearity of price. Due to its built-in price quantity structure, the scheme performs as designed regardless of the elasticities of marginal damage and demand functions.

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