

On the Bilateral Contracting Process in Economies with Externalities*

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Abstract

This paper examines whether an efficient outcome can be achieved through the bilateral contracting processes in a noncooperative coalitional bargaining game model with externalities and renegotiations. We describe the bargaining situation in a strategic form game. When the members of coalitions make binding agreements about their actions and transfers in the coalition formation process, almost all Markov perfect equilibria converge to the efficient state. On the other hand, in the partition function form game situation, all equilibria may remain in an inefficient state forever even if the grand coalition is efficient.

Key words: Coalitional bargaining, bilateral contracting, externalities, strategic form game

JEL Classification: C72, C78, D62

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