

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 trying to exploit all gains from trade, may in fact be solved by taxation. Thus, in our framework Coasean bargaining is not a substitute for Pigouvian taxation, instead it is the very reason for government intervention.