Abstract:
We analyze a bilateral trade model where, after the buyer makes a take-it-or-leave-it offer, the seller can make a costly investment which increases the common value of the good in expectation.
The seller must decide whether to trade before fully knowing the investment outcome. The efficiency of the trading outcome is undermined by two types of inefficiency, the adverse selection problem in trade (ex-post inefficiency); and the seller's moral hazard problem to invest (ex-ante inefficiency). The adverse selection problem is mitigated when the seller is relatively uninformed of the investment outcome and only mildly pessimistic. However, the seller is incentivized to invest only if the seller is relatively certain of the investment outcome and sometimes chooses not to trade. Therefore, the information structure that achieves the second-best outcome leave the seller mildly pessimisic upon trade occuring, and sufficiently optimistic when trade fails.