The Dreze and Grossman-Hart criteria for production in incomplete markets: Voting foundations and compared political stability*

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March 2004

Abstract [t]

This paper studies corporate control in a general equilibrium model with incomplete markets. At the market equilibrium, shareholders typically disagree on the way to evaluate production plans outside the market span. Hence a collective decision mechanism is needed to resolve this conflict. A, mechanism proposed by Dreze (1974), resp. Grossman & Hart (1979), consists in allowing (Lindahl-like) sidepayments between final, resp. initial, shareholders. Although it is likely to exhibit desirable efficiency properties, this mechanism is difficult to implement. Another mechanism (e.g., Dreze (1985) and De-Marzo (1993)) relies on majority voting by shareholders. Since voting occurs in a multi-dimensional setup, super majority rules are needed to ensure existence of equilibria. We give conditions under which sidepayment equilibria are voting equilibria for the smallest rate of super majority ensuring existence: Thereby we are able to compare the relative performances of the Dreze and Grossman-Hart criteria with respect to stability in the voting mechanism- We show that the endogenization of portfolio holdings in the Dreze criterion can either help or completely jeopardize the aggregation process, depending on the shareholders' expectations. This ambivalence is absent in the Grossman-Hart criteria.

Keywords: Incomplete markets, super majority voting, sidepayments, corporate charter, self-fulfilling prophecies.