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Second-best Road Pricing

This lecture addresses the economics of second-best road pricing. The lecture explains why second-best pricing is so much more relevant in practice than first-best pricing. We then discuss some main principle of second-best pricing: why it is no longer true that corrective taxes be set equal to marginal external cost, and why welfare gains from pricing are typically smaller than in first best. We then show how Lagrangian techniques can be used to derive second-best taxes, and how to interpret the associated Lagrangian multipliers and the second-best tax rules. We next discuss how the relative efficiency from second-best pricing depends on demand and cost elasticities. Finally, we illustrate how the same techniques can be used to derive second-best rules for non-tax instruments.