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“Providing Certainty”

(joint with Andy Choi and Chengyang Zhu)

Abstract: A principal chooses a policy at a future date, and wishes to match the policy to an uncertain state. An agent chooses when to make an irreversible investment, and wishes to invest only if he expects the policy will be favorable. Information about the state is publicly and gradually revealed over time. Moral hazard arises because the agent wishes to wait for more information. To incentivize the agent to invest early, it is optimal for the principal to provide certainty about her future policy. This is inefficient -- the agent's benefit from certainty is always outweighed by the principal's cost from reduced policy flexibility. We characterize conditions under which the agent receives positive rent, and provide sufficient conditions for moral hazard to delay investment. Our results apply to environmental subsidy programs and the incentivization of R & D.