

Non-Market Screening with Investment

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Abstract:

Rewards such as prizes, labels, certifications, grants, market authorizations, positions, and promotions are often allocated on the basis of a measured characteristic of agents, or *score*. We study how a principal should allocate such rewards when the score is used to target deserving recipients, and agents can undertake costly investments to improve the characteristic measured by the score. We show that, even when the principal internalizes agents' investment incentives, simple *cutoff rules* are optimal under natural conditions on the principal's preferences, agents' investment costs, and the distribution of agents' types. This result provides a theoretical foundation for the widespread use of cutoff rules in practice.