A Reputational Theory of Firm Dynamics*

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Abstract

We study the lifecycle of a firm that produces a good of unknown quality. The firm manages its quality by investing, while consumers learn via public breakthroughs; if the firm fails to generate such breakthroughs, its revenue falls and it eventually exits. Optimal investment depends on the firm’s reputation (the market’s belief about its quality) and self-esteem (the firm’s own belief about its quality), and is single-peaked in the time since a breakthrough. We derive predictions about the distribution of revenue, and propose a method to decompose the impact of policy changes into investment and selection effects.

1 Introduction

In many markets, consumers have imperfect information about the quality of the products they purchase. A patient undergoing surgery would like to know the competence of their surgeon, a restaurant patron would like to know about the hygiene of the establishment, and an investor would like to know about the returns of a mutual fund. This paper investigates the incentives that “firms” (e.g. surgeons, restaurants, mutual funds) have to invest in order to maintain their quality. In particular, we study investment and exit decisions over their lifecycle, and derive implications for the dynamics of reputation and the cross-sectional distribution of revenue.

Our paper provides a framework to study investment and selection effects in industries where the market learns quality over time. In contrast to models of perfect information, like Ericson and Pakes (1995), a firm’s most important assets are the market’s belief of its quality (its “reputation”) and the firm’s own belief of its quality (its “self-esteem”). These state variables differ from traditional capital assets in important aspects. First, reputation depends on the market’s beliefs about the firm’s investment, rather than actual investment. The resulting moral hazard problem dampens incentives, and qualitatively changes firm dynamics. Specifically, we suppose customers learn about

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quality from public breakthroughs; investment then decreases in the time since a breakthrough when investment is observable, but is single-peaked when investment is unobservable. Second, in a perfect information model, price-taking firms invest and exit efficiently, leaving no role for policy to improve welfare. In contrast, our model permits meaningful analysis of disclosure policies that improve the market’s information, e.g. by publishing surgeon report cards, or requiring restaurant to post health grades. We additionally propose a method to decompose the impact of such policies into investment and selection effects. Third, reputation varies as news arrives, and is thus volatile even if the underlying product quality is stable. For example, when a restaurant is featured in the New York Times, demand jumps even though the quality does not change. Hence, one needs a model to be able to infer the volatility of quality from the volatility of restaurant revenue; we discuss how our model can do exactly this.

In the model, a long-lived firm sells a product of high or low quality to a continuum of identical, short-lived consumers. The firm chooses how much to invest in the quality of its product; it can also exit at any time. Consumers observe neither the firm’s investment history nor the resulting quality. Rather, they learn about quality via public breakthroughs that can only be generated by a high-quality product. We call the market’s belief that quality is high, \( x_t \), the firm’s reputation and assume that it determines revenue. Likewise, the firm does not observe quality directly, but learns about it via the same breakthroughs; unlike the market, it can also recall its past investments. We call the firm’s belief that quality is high, \( z_t \), the firm’s self-esteem.

In a pure-strategy equilibrium, reputation and self-esteem coincide on-path. However, since the market does not observe deviations from equilibrium, investment incentives are determined by the marginal value of self-esteem off-path. We characterize the firm’s optimal investment and exit decisions over its lifecycle, focusing on recursive equilibria where reputation is solely a function of the time since the last breakthrough.

Our first result represents the marginal value of self-esteem, and hence investment incentives, as an integral over future reputational dividends that derive from an increased chance of breakthroughs. Using this characterization we show that, in any pure strategy equilibrium, incentives are single-peaked in the time since the last breakthrough (Theorem 1). Immediately after a breakthrough, the firm is known to be high quality and does not benefit from another breakthrough. At the opposite extreme, when the firm is about to exit, it cuts investment to zero. Intuitively, investment only pays off if investment affects quality and quality is revealed via a breakthrough. When the firm is \( dt \) from exiting, the joint probability of these two events is of order \( dt^2 \), and therefore the marginal benefit of investment vanishes. Investment incentives are thus maximized at an intermediate time; we formally show that they are single-peaked.

Next, we prove equilibrium exists (Theorem 2), possibly in mixed strategies. The proof defines a topology on strategies that allow us to apply the Kakutani-Fan-Glicksberg fix-point theorem.\(^1\)

To illustrate the applicability of the model we use the Kolmogorov forward equation to examine how learning, investment and entry jointly shape the steady-state distribution of reputation. Additionally, we propose a method to decompose the drivers of steady-state revenue into investment and selection effects. This decomposition is particularly useful in interpreting comparative statics, such as a disclosure policy that raises the frequency of breakthroughs, or a minimum wage that raises operating costs. As a proof of concept, we use a simple simulation to show that a disclosure policy

\(^1\)Other papers, e.g. Cisternas (2017), establish existence constructively from the firm’s adjoint equation. The problem with this approach in our setting is that the firm’s first-order condition for investment is not sufficient for optimality; in particular, investments are strategic complements, and so multi-step deviations may be optimal.
may have little effect on mean steady-state reputation but drastically raise the relative importance of investment over selection.

Section 4 considers two model variants that isolate the two different economic forces behind the single-peaked incentives in the baseline model. They also illustrate how the information structure in the market affects firms’ incentives to invest. In the first variant, we assume the market observes the firm’s investment. Thus, both the firm and the market symmetrically learn about the firm’s quality, but there is no moral hazard. We show that investment decreases in the time since a breakthrough, as the firm approaches bankruptcy (Theorem 3). In the second variant, we assume the firm knows its own quality in addition to its investment, while the market knows neither. We show that investment increases in the time since a breakthrough, as the benefit from a breakthrough grows (Theorem 4). In stark contrast to the baseline model, investment is maximized at the exit threshold; crucially, the firm immediately observes when investment raises quality, and then chooses to remain in the market. The single-peaked investment in the baseline model combines the decreasing incentives in the first variant and the increasing incentives in the second variant.

Our model provides a natural lens through which to study the reputation and revenue dynamics of surgeons, restaurants and mutual funds. In Section 5, we discuss how one might identify the model parameters from data in these industries. We also discuss how to weaken our more stylized assumptions, such as the perfect good news learning structure.

1.1 Literature

Our model draws inspiration from two canonical models of firm dynamics. Jovanovic (1982) assumes that firms and consumers symmetrically learn about the firms’ quality, but abstracts from investment. Ericson and Pakes (1995) assume firms invest in the quality of their products, but suppose there is complete information. We combine learning and investment and characterize how these forces jointly shape investment incentives and firm dynamics.

There is a variety of other models of firm lifecycles. Hopenhayn (1992) assumes firm capabilities change over time according to a Markov process, and studies the resulting entry and exit patterns. Cabral (2015) considers a reduced-form model of reputational firm dynamics, where reputation is modeled as a state variable akin to capital stock, rather than being derived from Bayes’ rule. Gale and Rosenthal (1994) and Rob and Fishman (2005) consider the dynamics of repeated game equilibria where incentives arise from punishment strategies.

The paper is related to the literature on reputation, especially our prior paper (Board and Meyer-ter-Vehn, 2013). The current paper introduces exit, allowing us to study firm lifecycles; this is of interest for three reasons. First, the possibility of exit qualitatively changes the nature of incentives, as illustrated by the difference between the single-peaked incentives in the baseline model, and the increasing incentives when the firm knows its quality (without exit, there is no difference between these models). Second, the model provides an empirical framework to study industry dynamics and productivity dispersion, and to measure the impact of disclosure policies and minimum wages. Third, the exit decision introduces new methodological challenges, since we must keep track of both reputation and self-esteem. As such, we contribute to the growing literature on learning models with moral hazard; such models have the feature that private and public beliefs differ off-path. Bonatti and Hörner (2011, 2017) consider incentives in a strategic experimentation game. Sannikov (2014) considers a contract design problem in which the agent’s effort has long-run effects on her employer’s performance. Cisternas (2017) analyzes a general model
of two-sided learning with moral hazard; his incentive equation is analogous to our “marginal value of self-esteem.”

We hope that the paper speaks to the growing empirical literature studying industry dynamics with imperfect information. Jin and Leslie (2003, 2009) and Luca (2016) study how hygiene grades and Yelp scores affect restaurants. Cutler, Huckman, and Landrum (2004) and Kolstad (2013) study how medical report cards affect the behavior of surgeons. Cabral and Hortacsu (2010) consider the impact of negative feedback on eBay sellers. There are many more papers that examine the effect of new information on customers’ decisions such as health plan choice (Jin and Sorensen, 2006), hospital choice (Pope, 2009), doctors’ prescriptions (Arrow, Bilir, and Sorensen, 2017), school choice (Hastings and Weinstein, 2008), college applications (Luca and Smith, 2013), caloric intake (Bollinger, Leslie, and Sorensen, 2011), and the demand for books (Sorensen, 2007).

The paper provides a model of brand dynamics, which are often modeled in an informal way. For example, Bronnenberg, Dubé, and Gentzkow (2012) study the dynamics of brand shares when customers move between cities and their preferences depend on past purchases. Similarly, Foster, Haltiwanger, and Syverson (2016) model the slow demand growth of new entrants by assuming the level of current demand depends on the stock of past demand, which the authors interpret as the “growth of a customer base or building a reputation.” More broadly, the paper helps explain the variability in productivity and profits within industries, whereby some firms invest in their assets and grow, while others disinvest and shrink (see, for example, Syverson (2011)).

2 Model

Players and actions: A long-lived firm faces a mass of short-lived consumers, also referred to as the market. Time $t \in [0, \infty)$ is continuous. At every time $t$ the firm chooses an investment level $A_t \in [0, \overline{a}]$ where $\overline{a} < 1$; it may also choose to exit the market at time $T \in [0, \infty)$, thereby ending the game.

Technology: At time $t$ the firm’s product quality is $\theta_t \in \{L, H\}$, where $L = 0$ and $H = 1$. Initial quality $\theta_0$ is exogenous; subsequent quality depends on investment and technology shocks. Specifically, shocks are generated according to a Poisson process with arrival rate $\lambda > 0$. Quality $\theta_t$ is constant between shocks, and determined by the firm’s investment at the most recent technology shock $s \leq t$; i.e., $\theta_t = \theta_s$ and $\Pr(\theta_s = H) = A_s$. This captures the idea that quality is a lagged function of past investments.

Information: Consumers observe neither quality nor investment, but learn about quality through public breakthroughs. Given quality $\theta$, breakthroughs are generated according to a Poisson process with arrival rate $\mu \theta$; that is, breakthroughs only occur when $\theta = H$. We write $h^t$ for histories of breakthrough arrival times before time $t$ and $h$ for infinite histories.

The firm does not observe product quality either, but does recall its past actions. Formally, the firm’s investments $A := \{A_t\}_{t \geq 0}$ control the distribution of quality $\{\theta_t\}_{t \geq 0}$ and thereby the histories of breakthroughs $h$; we write $E^A$ for expectations under this measure and call $Z_t = E^A [\theta_t | h^t]$ the firm’s self-esteem at time $t < T$. This reflects the firm’s belief of its own quality given its past investment and the history of breakthroughs.
We write (pure) market beliefs over investment and exit as \( \tilde{A} = \{\tilde{A}_t\}_{t \geq 0} \) and \( \tilde{T} \). The firm’s reputation is given by \( X_t := \mathbb{E}[\tilde{A}[\theta_t|h^t]] \) as long as \( t < \tilde{T} \). Initially, self-esteem and reputation are exogenous and coincide, \( X_0 = Z_0 \).

**Payoffs:** The firm and consumers are risk-neutral and discount future payoffs at rate \( r > 0 \). At time \( t \), the firm produces one unit with flow value that we normalize to \( \theta_t \). Given the public information \( h^t \), consumers’ willingness to pay equals the firm’s reputation \( X_t \); following Holmström (1999), we assume that the firm’s revenue equals the willingness to pay. The firm incurs operating cost \( k \in (0, 1) \) and investment costs \( c(A_t) \), so the firm’s flow profits are given by \( X_t - k - c(A_t) \); we assume that \( c(\cdot) \) is smooth, strictly increasing and convex, with \( c(0) = 0 \).

Given the firm’s strategy \((A, T)\) and market beliefs \((\tilde{A}, \tilde{T})\), its expected present value equals

\[
\mathbb{E}^A \left[ \int_{t=0}^{T} e^{-rt}(X_t - k - c(A_t)) dt \right].
\]

Market beliefs \( \tilde{A} \) thus determine the firm’s revenue \( X_t = \mathbb{E}[\tilde{A}[\theta_t|h^t]] \) for a given history \( h^t \), while actual investment \( A \) determines the distribution over histories \( h^t \), and the exit time \( T \) determines the integration domain.

**Recursive Strategies:** Both reputation and self-esteem are reset to \( X = Z = 1 \) at a breakthrough; between breakthroughs the market observes no information about the firm’s performance. For this reason, we consider recursive strategies which only depend on the time since the last breakthrough. Formally, we call strategy \((A, T)\) recursive if there exists a deterministic process \( a = \{a_t\} \) and exit time \( \tau \in [0, \infty) \) such that if the last breakthrough before \( t \) was at time \( s \), then \( A_t = a_{t-s} \) and \( \tau = T - s \). We write recursive strategies as \((a, \tau)\) and the resulting recursive self-esteem as \( z = \{z_t\} \), where \( z_0 = 1 \). Similarly define recursive beliefs \((\tilde{a}, \tilde{\tau})\) and denote the induced recursive reputation by \( x = \{x_t\}, \) where \( x_0 = 1 \). Given recursive reputation \( x = \{x_t\} \), we can restrict the firm’s problem to recursive strategies, and we omit the qualifier “recursive” throughout most of the paper.

Self-esteem is governed by the firm’s investment and the history of breakthroughs. At a breakthrough, self-esteem jumps to one. Absent a breakthrough, self-esteem is governed by \( \dot{z}_t = g(a_t, z_t) \) where the drift is given by

\[
g(a, z) = \lambda(a - z) - \mu z(1 - z).
\]

The first term derives from the technology process: with probability \( \lambda dt \) a technology shock hits in \([t, t + dt]\), previous quality becomes obsolete, and the current quality is determined by the firm’s investment. This term is positive if investment \( a_t \) exceeds the firm’s self-esteem \( z_t \) and negative otherwise. The second term derives from the absence of breakthroughs and is always negative.

Truncating the integral in (1) at the first breakthrough (which arrives at rate \( \mu z_t \)), the firm’s continuation value at time \( t \) is

\[
V(t, z_t) = \sup_{a, \tau} \int_t^\tau e^{-\int_s^\tau (r + \mu z_u) du} (x_s - k - c(a_s) + \mu z_s V(0, 1)) ds.
\]

We write optimal strategies as \((a^*, \tau^*)\) and the associated self-esteem as \( z^* = \{z_t^*\} \).

\( ^2 \)We discuss mixed beliefs in the context of equilibrium existence in Appendix B.
We assume that, given (pure) beliefs \((\hat{a}, \hat{\tau})\), reputation \(x = \{x_t\}\) is continuous and strictly decreases in the time since a breakthrough,\(^3\) and the firm eventually exits, \(\tau^* < \infty\). To guarantee exit, we suppose that

\[
z^\dagger := \frac{\lambda}{\mu} < 1 \quad \text{and} \quad z^\dagger - k + \mu z^\dagger (1 - k)/r < 0.
\]

(4)

The first inequality ensures that drift (2) is negative on \([z^\dagger, 1]\), so both self-esteem and reputation eventually drop below \(z^\dagger\) absent a breakthrough. At that point, the second inequality ensures that the integrand in (3) is negative and the firm exits, where \((1 - k)/r\) serves as an upper bound for \(V(0, 1)\). Additionally, we suppose that the market draws no positive inference from the off-path event that the firm fails to exit at time \(\hat{\tau}\).

**Remarks:** The model makes several assumptions of note. First, as in Board and Meyer-ter-Vehn (2013), we assume that quality at time \(t\) is based on investment at the time of the last technology shock. While “upgrades” are natural, there two ways to think of “downgrades” in our model. One can interpret investment as the choice of absorptive capacity, determining the ability of a firm to adapt to a changing world (Cohen and Levinthal (1990)). Alternatively, one can think of a firm’s quality as its advantage over a competitive fringe that advances one rung on a quality ladder at each technology shock. Our specification has two substantive implications. It implies that high- and low-quality firms are equally good at investing, so we do not hard-wire in any complementarity or substitutability between current quality and investment.\(^4\) It also means that believed investment affects reputation continuously, via its drift (2); this contrasts with other recent models of endogenous persistent states, where equilibrium beliefs can lead to jumps in reputation (e.g. Dilme (2018), Halac and Prat (2016)).

Second, we assume “perfect good news learning” where information arrives via breakthroughs that reveal high quality. This stylized information structure allows us to analyze our model in terms of recursive strategies (that depend on the time since the last breakthrough and self-esteem) rather than Markovian strategies (that depend on the reputation and self-esteem), helping us to prove equilibrium existence.\(^5\) The intuition behind our single-peaked incentives extends to imperfect good news Poisson or Brownian signals (see Section 5).

Third, while our formal results concern the lifecycle of a single firm, one can think of the firm as operating in a competitive industry in steady state, such as the restaurant industry or the market for surgeons. For example, Atkeson, Hellwig, and Ordoñez (2014) suppose firm \(i\)’s revenue equals \(p_t x_{t,i}\), where the price is determined by aggregate supply \(p_t = p(\int_i x_{t,i} \, di)\). This market interpretation allows us to consider the implications of the model for the cross-sectional distribution of revenue. The one caveat is that our comparative statics (see Section 3.5) take market prices as fixed. This is reasonable if demand \(p(\cdot)\) is elastic; otherwise, policy changes will impact prices as well as quantities.

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\(^3\)We relax this assumption when discussing mixed beliefs and proving equilibrium existence in Appendix B.

\(^4\)We could equivalently assume that quality at a breakthrough is separable in previous quality and current investment. For example, a model with \(\Pr(\theta_\tau = H) = (A_s + \theta_s)/2\) is isomorphic to our model with arrival rate of technology shocks equal to \(\lambda/2\).

\(^5\)In particular, if the market has mixed beliefs over Markovian investment strategies, reputation \(x_t\) is not a sufficient statistic for market beliefs and one would have to keep track of the market’s belief about \(z_t\), that is, the market’s second-order belief about quality.
3 Analysis

Section 3.1 analyzes the firm’s optimal strategy for general market beliefs, showing that investment incentives are single-peaked in the time since a breakthrough. The key step is to express the marginal value of self-esteem as an integral of a series of dividends. Section 3.2 proves equilibrium existence, while Section 3.3 characterizes the cross-sectional distribution of revenue. Section 3.4 simulates the model and decomposes the drivers of reputation into investment and selection effects. Finally, Section 3.5 shows how to use the model to quantify the impact of disclosure policies and minimum wages.

3.1 The Firm’s Problem

Fix arbitrary beliefs \((\bar{a}, \bar{\tau})\) with associated continuous, strictly decreasing reputation \(\{x_t\}\), and let \((a^*, \tau^*)\) be an optimal recursive strategy for the firm. For starters, we note that firm value \(V(t, z)\) strictly decreases in \(t\) and strictly increases in \(z\). The first claim follows from our assumption that reputation, and hence revenue, decreases over time. The second claim follows since self-esteem raises the chance of a breakthrough that raises reputation and revenue. See Appendix A.1 for a formal argument.

We now consider investment incentives. Investment raises the firm’s quality, its self-esteem, and thus its value. In particular, equation (2) implies that investment raises self-esteem at rate \(c'(a^*)\), so the marginal benefit of investing is \(\lambda V_z(t, z^*)\), whenever this derivative exists. Optimal investment \(a^*_t \in (0, \bar{a})\) thus satisfies the first-order condition

\[
\lambda V_z(t, z^*_t) = c'(a^*_t) \tag{5}
\]

with \(a^*_t = 0\) if \(\lambda V_z(t, z^*_t) < c'(0)\), and \(a^*_t = \bar{a}\) if \(\lambda V_z(t, z^*_t) > c'(\bar{a})\).

To address the differentiability issue, observe that the firm’s value \(V(t, z)\) is convex in \(z\). This follows because firm payoff for any fixed strategy \((a, \tau)\) is linear in \(z\), and \(V(t, z)\) is the upper envelope of such linear functions. Intuitively, convexity captures the value of information. For example, at the exit time, information about quality is valuable since good news raises self-esteem and value, while the option to exit protects the firm from bad news; formally, \(0 = V(t, z - \epsilon) = V(t, z) < V(t, z + \epsilon)\). Convexity implies that even if the value function is not differentiable, it admits directional derivatives \(V_z^-(t, z), V_z^+(t, z)\).

Given the first-order condition (5), we need to understand the marginal value of self-esteem. Our next result, the work-horse of this paper, expresses \(V_z(t, z^*_t)\) in terms of future reputational dividends.

**Lemma 1 (Marginal Value of Self-Esteem).** If \(V_z(t, z^*_t)\) exists, it equals

\[
\Gamma(t) := \int_t^{\tau^*} e^{-\int_t^s \lambda + \mu(1-z_u)du} \mu [V(0, 1) - V(s, z^*_s)] ds. \tag{6}
\]

More generally \(V_z^-(t, z^*_t) \leq \Gamma(t) \leq V_z^+(t, z^*_t)\).

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\(^6\)Existence of an optimal strategy follows from the proof of equilibrium existence, Theorem 2.

\(^7\)See equation (21) in Appendix A.2.
Proof. Equation (6) is an integral version of the adjoint equation for the firm’s control problem. It follows by differentiating firm payoff for a fixed strategy \((a^*, \tau^*)\) with respect to the firm’s initial self-esteem \(z\). The relationship to the (directional) derivative of the value function follows by the envelope theorem. See Appendix A.2 for details.

Intuitively, quality and self-esteem raise the probability of a breakthrough and, since they are persistent, pay off dividends over time. That is, incremental self-esteem \(dz\) raises the probability of a breakthrough in \([t, t + dt]\) by \(\mu dz dt\), while the value of a breakthrough equals \(V(0, 1) - V(t, z^*_t)\). We thus call the integrand \(\mu(V(0, 1) - V(s, z^*_s))\) the reputation dividend of self-esteem. The dividend stream from the increment \(dz\) depreciates for three reasons. First, time is discounted at rate \(r\); second, at rate \(\mu z^*_t\) a breakthrough arrives, self-esteem jumps to one, and the increment disappears; third, reputational drift (2) is not constant in \(z\), and its derivative equals \(g_z(a^*_t, z^*_t) = - (\lambda + \mu(1 - 2z^*_t))\). Summing these three components yields the discounting term in (6).

If there is a single optimal strategy \((a^*, \tau^*)\), the derivative \(V_z(t, z^*_t)\) exists and coincides with \(\Gamma(t)\). If there are multiple optimal strategies, then \(V_z(t, z^*_t)\) does not exist and each solution gives rise to a different trajectory of self-esteem \(z^*_t\) and a different value of \(\Gamma(t)\). However, for any \((a^*, \tau^*)\), equation (6) is well-defined, bounded by the directional derivatives of \(V\), and describes the firm’s investment incentives given \((a^*, \tau^*)\). This implies the following necessary condition for optimal investment:

**Lemma 2 (Optimal Investment).** Any optimal strategy \((a^*, \tau^*)\) satisfies

\[
\lambda \Gamma(t) = c'(a^*_t) \tag{7}
\]

with \(a^*_t = 0\) if \(\lambda \Gamma(t) < c'(0)\) and \(a^*_t = \bar{a}\) if \(\lambda \Gamma(t) > c'(\bar{a})\) for almost all \(t\).

Proof. For a fixed optimal strategy \((a^*, \tau^*)\) with associated trajectory \(\{z^*_t\}\), equation (6) captures the marginal benefit of increasing \(z^*_t\). So, if \(\lambda \Gamma(s) > c'(a^*_s)\) for \(s \in [t, t + \epsilon]\), say, then the firm could raise its payoff by raising its investment \(a_s\) at those times.

**Theorem 1.** Optimal investment \(\{a^*_t\}\) is single-peaked in the time since a breakthrough \(t\);\(^9\) at the exit threshold, \(a^*_\tau = 0\). The optimal exit time \(\tau^*\) satisfies

\[
x_{\tau^*} - k + \mu z_{\tau^*} V(0, 1) = 0. \tag{8}
\]

Proof. We wish to show that \(\Gamma(t)\) is single-peaked in \(t\), with boundary conditions \(\Gamma(0) > 0, \dot{\Gamma}(0) > 0\) and \(\Gamma(\tau^*) = 0\). Taking the derivative of investment incentives (6) and setting \(\rho(t) := r + \lambda + \mu(1 - z^*_t)\) yields the adjoint equation

\[
\dot{\Gamma}(t) = \rho(t) \Gamma(t) - \mu(V(0, 1) - V(t, z^*_t)). \tag{9}
\]

Now assume that \(\rho(t)\) and \(V(t, z^*_t)\) are differentiable. Then \(\dot{\rho}(t) = -\mu z^*_t\) and \(\frac{d}{dt} V(t, z^*_t) = z^*_t \dot{\Gamma}(t) + V_z(t, z^*_t)\); in Appendix A.3 we show that these functions are indeed absolutely continuous

\(^8\)Changing investment at a measure zero set of times does not affect payoffs, so any statements about optimal investment hold only almost always; hereafter we omit this qualifier. It can also be eliminated by restricting the firm to forward-continuous strategies (see Board and Meyer-ter-Vehn, 2013).

\(^9\)That is, \(a^*_t\) increases on \([0, s]\) and decreases on \((s, \tau^*)\) for some \(s \in (0, \tau^*)\).
and extend our arguments to that case. The derivative of the adjoint equation equals

\[ \dot{\Gamma}(t) = \rho(t)\dot{\Gamma}(t) + \dot{\rho}(t)\Gamma(t) - (-\mu \frac{d}{dt}V(t, z^*_t)) = \rho(t)\dot{\Gamma}(t) + V_t(t, z^*_t) \tag{10} \]

Since \( V_t(t, z^*_t) < 0 \), \( \dot{\Gamma}(t) = 0 \) implies \( \dot{\Gamma}(t) < 0 \), hence \( \Gamma(t) \) is single-peaked or decreasing. To see that it is actually single-peaked observe that, when \( t = 0 \), equation (6) implies \( \Gamma(0) > 0 \) because the integrand \( \mu(V(0, 1) - V(s, z^*_s)) \) is strictly positive for \( s \in [0, \tau^*] \). Equation (9) then implies \( \dot{\Gamma}(0) = \rho(0)\Gamma(0) > 0 \). Finally, when \( t = \tau^* \), equation (6) immediately implies that \( \Gamma(\tau^*) = 0 \).

To understand the exit condition (8), recall that the firm’s value is given by (3) and that \( \{x_t\} \) is continuous and decreasing. When the firm shirks, its flow payoff is \( x_t - k \), and its option value of staying in the market has a flow value of \( \mu z^*_t V(0, 1) \). Thus, if \( x_t - k + \mu z^*_t V(0, 1) > 0 \) the firm can raise its payoff by shirking and staying in the market. Conversely, if \( x_{\tau^*} - k + \mu z^*_t V(0, 1) < 0 \) then \( x_t - c(a_t) - k + \mu z^*_t V(0, 1) < 0 \) for \( t \) just before \( \tau^* \) and any investment \( a_t \), and the firm would have been better off exiting a little earlier.

The evolution of investment incentives is shaped by two countervailing forces. Just after a breakthrough, an additional breakthrough has no value and the reputational dividend is zero; investment incentives (6) depend on current and future dividends, so \( \Gamma(0) \) is small but positive. As time progresses, future larger dividends draw closer and \( \Gamma(t) \) rises. At the other extreme, investment vanishes at the exit time \( \tau^* \) because there is no time left for the investment to pay off. That is, the benefit of investment is of second order because both a technology shock and a breakthrough must arrive in the remaining time interval for the investment to avert exit. In Sections 4.1 and 4.2, we present two model variants where we switch off each of these forces in turn and show that investment incentives are, respectively, decreasing and increasing in the time since a breakthrough.

This intuition suggests that investment incentives are small at the extremes. More strongly, Theorem 1 shows that incentives are single-peaked. A more precise intuition is as follows. As \( t \) rises the firm loses the reputational dividends over \([t, t + dt]\), as captured by the second term in (9). This negative effect becomes more important over time as the reputational dividend increases, as captured by the positive term \(-\mu \frac{d}{dt}V(t, z^*_t)\) in (10). On the upside, an increase in \( t \) brings future and larger dividends closer, as captured by the first term in (9). Ignoring the time dependence of \( \rho(t) \), this positive effect becomes less important over time once incentives start decreasing. Thus once incentives decrease, the negative effect keeps growing while the positive effect decreases, and so incentives decrease until exit.

At the end of its life the firm’s flow profits \( x_t - k \) are negative but it remains in the market for the option value of a last-minute breakthrough that boosts its reputation and self-esteem to one. Over time, losses grow and the option value diminishes. The firm exits when they exactly offset each other, as expressed by equation (8).

Observe that when exit is imminent, the firm ceases to invest, accelerating its demise. As an example of this, Goldfarb (2007) argues that the brewer Schlitz realized that the rise of Miller would have a large impact on its future profitability. This led it to disinvest in the brand by changing the preservatives, switching to lower quality accelerated batch fermentation, and firing much of its marketing team. These patterns are not seen in classic industry models like Jovanovic (1982) that abstract from investment, meaning the reputation of the firm is a martingale.
3.2 Equilibrium

So far we have studied a firm’s optimal strategy for arbitrary, pure beliefs \((\bar{a}, \bar{\tau})\) and associated revenue trajectories \(\{x_t\}\). In this section, we close the model by assuming that market beliefs are correct.

An equilibrium consists of a distribution over recursive investment and exit strategies \((a, \tau)\) and a recursive reputation trajectory \(\{x_t\}\) such that: (a) Given \(\{x_t\}\), all equilibrium strategies \((a, \tau)\) solve the firm’s problem (3); and (b) reputation \(\{x_t\}\) is derived from the firm’s strategy by Bayes’ rule, whenever possible.\(^{10}\)

This definition allows for mixed strategies; Bayesian updating is more subtle with mixed beliefs since the market draws inferences from the fact that the firm has not exited. We spell this out in Appendix B.1 and discuss the qualitative properties of such equilibria in Appendix B.2.

Fixing a candidate strategy \((a, \tau)\), the marginal value of self-esteem (6) and the first-order condition (7) are necessary for optimality. However, these equations are not sufficient since they correspond to checking only “one-step deviations on path.” We must take this problem seriously since the firm’s investment exhibits dynamic complementarity: Investment today raises tomorrow’s marginal benefit of self-esteem and thus optimal investment. Formally, this follows from the convexity of value \(V\) in \(z\); intuitively, today’s investment raises the firm’s life expectancy which means it has longer to benefit from a potential breakthrough.\(^{11}\) We thus do not use these equations to establish equilibrium existence, but rather apply a fixed point argument.

**Theorem 2.** An equilibrium exists.

*Proof.* The best-response correspondence maps revenue \(\{x_t\}\) to optimal strategies \((a^*, \tau^*)\). Bayes’ rule maps strategies \((a, \tau)\) into reputation \(\{x_t\}\). The Kakutani-Fan-Glicksberg Theorem then yields a fixed point. The key step in the proof is to define the appropriate weak topology that renders the strategy space compact and the two correspondences continuous. See Appendix B.1 for details. \(\square\)

Equilibrium dynamics can take different forms. To illustrate this, suppose cost is linear, \(c(a) = ca\) for \(a \in [0, \bar{a}]\). Low costs \(c\) give rise to a “probationary equilibrium” where the market assumes a firm invests for a fixed period of time after each breakthrough, but then grows suspicious. The firm’s reputation initially drifts down slowly, as the favorable beliefs about investment offset the bad news conveyed by the lack of breakthroughs. After enough time without a breakthrough, market beliefs turn against the firm, and the perceived disinvestment hastens the firm’s decline.

Dynamics are different if the marginal cost is higher, and the firm’s initial incentives \(\Gamma(0)\) are insufficient to motivate effort. After a breakthrough, the firm rests on its laurels because it has little to gain from an additional breakthrough. As its reputation and self-esteem drop, it starts investing and works hard for its survival, but eventually gives up and shirks before exiting the market.

\(^{10}\)This definition does not impose sequential optimality of strategy \((a, \tau)\) and thus corresponds to Nash equilibrium rather than sequential equilibrium. This is for notational convenience and is without loss. Indeed, the firm’s investment is unobservable, so deviations do not affect beliefs and revenue. Thus, any equilibrium is outcome-equivalent to a sequential equilibrium. In fact, all of the analysis in Section 3.1 starting at states \(t, z_t^*\) extends immediately to optimal strategies starting at any state \(t, z\).

\(^{11}\)This strategic complementarity stands in contrast to the strategic substitutability in Bonatti and Hörner (2011). There, a player who exerts more effort today is more pessimistic about the state of the project tomorrow when his effort fails to result in the desired breakthrough.
3.3 Steady State Distribution

These reputational dynamics shape the distribution of reputation and revenue in the industry. Consider a continuum of price-taking firms, such as that studied above, and assume that new firms enter the market continuously at rate $\phi$ with reputation drawn with density $h$ on $[x^c, 1]$, where $x^c = x_r$ is the reputation at the exit time. The measure of firms $f(x, t)$ with reputation $x \in [x^c, 1]$ at time $t$ is governed by the Kolmogorov forward equation

$$\frac{\partial}{\partial t} f(x, t) = -\frac{\partial}{\partial x} [f(x, t)g(x)] - \mu x f(x, t) + \phi h(x).$$

In steady state, $f(x, t) \equiv f(x)$ and entry and exit coincide, $\phi := -g(x^c)f(x^c)$. We can also normalize the total mass of firms to integrate to one, and interpret $f(\cdot)$ as a distribution. Rearranging, we get

$$f'(x) = \frac{g'(x)}{-g(x)} f(x) + \frac{\mu x}{-g(x)} f(x) - \frac{\phi h(x)}{-g(x)}.$$

(11)

To understand this equation, suppose as a benchmark that firms all enter at $x = 1$ and drift down at a constant rate $g(x) \equiv g < 0$ until they exit; if there are no breakthroughs, firms are uniformly distributed on $[x^c, 1]$, and so $f'(x) = 0$. The first term then captures the idea that firms accumulate where the downward drift is slowest, e.g. where the firm invests. The second term captures the firms who receive breakthroughs and jump to $x = 1$; these jumps prevent firms from reaching lower levels of reputation, and so $f'(x) > 0$. The third term captures entry; so long as firms enter with reputations below 1, the downward drift implies that firms accumulate at lower levels of reputation, and so $f'(x) < 0$.

3.4 Simulation

In this section we simulate an equilibrium (see Figure 1). This serves two purposes: First, it illustrates the empirical features that the model can generate. Second, we use it as a test-case for policy experiments, proposing a method to decompose changes of average steady-state reputation into investment and selection effects.

This simulation considers a restaurant that has revenues of $\$x$ million a year, capital cost of $k = 500,000$, quadratic investment cost $c(a) = 0.2a^2$, a upper bound on investment $\bar{a} = 0.8$, and an interest rate of $r = 20\%$ (incorporating a risk premium). Good news arrives when the restaurant is written up in the local paper; we set $\mu = 1$, so that a high-quality restaurant is reviewed positively on average once a year. Finally, we set $\lambda = 0.2$, so that technology shocks arrive on average every 5 years. To make the figures easier to interpret, we replace the firm’s state variable $t$ with its time-$t$ reputation $x_t$.\footnote{To numerically solve for equilibrium, we start with a candidate investment strategy $\{a^0(t, z)\}$, calculate reputation $\{x_t\}$ given correct beliefs, and the resulting payoffs $\{V(x, z)\}$ via (3); we then derive optimal investment $\{a^1(t, z)\}$ via the first-order condition (7). We iterate this process until it converges; the fixed point satisfies the HJB $(r + \mu z) V(x, z) = \sup_a [x_t - k - c(a) + g(\bar{a}, x) Vz(x, z) + g(a, z) Vz(x, z) + \mu z V(1, 1)^a$, and has correct beliefs, $\bar{a} = a$. Hence it is an equilibrium.}

First, consider a single firm. Panel A illustrates the value function, which appears linear apart from the smooth-pasting at the exit point, $x^e = 0.22$; a firm with perfect reputation has value
$V = 1.27$. Panel B shows investment incentives $V_z$ on the whole state space $(x, z)$. One can see that $V_z$ increases in $z$, illustrating the convexity of the value function. Panel C shows investment along the equilibrium path where $x = z$, which corresponds to the 45° line of Panel B; one can see that investment is single-peaked (as in Theorem 1). Panel D then shows the typical lifecycle of a firm. Over the first two years its reputation falls despite the firm investing; shortly before it would have exited, a breakthrough boosts its reputation to one. Over the next two years the firm continues to maintain its high-quality and obtains a sequence of breakthroughs. Eventually this string of successes comes to an end (perhaps because it switches to low-quality, or perhaps because it is unlucky), and its reputation declines monotonically; ultimately it exits, $\tau^* = 3.4$ years after its last breakthrough.

We next consider the cross-sectional distribution of revenue and longevity, assuming firms enter with reputation equal to self-esteem, and uniformly distributed on $[x^e, 1]$. Panel E illustrates the distribution of revenue, showing that there are lots of firms at the top, with reputation $x \approx 1$, and also somewhat more firms at the exit point than in the middle. We can understand this using equation (11). The downward drift is relatively constant (see Panel D), so the first term can be ignored; intuitively, the positive drift from investment $\lambda(a - x)$ and the negative drift from market learning $\mu x(1 - x)$ are both are fastest in the middle and offset each other. The breakthroughs lead to lots of firms with reputation $x \approx 1$, while the entrants with low reputation raise the number of firms with reputation $x^e$. Panel F then illustrates the distribution of exit times: 45% of all firms fail in the first two years.\footnote{Coincidentally, Parsa, Self, Njite, and King (2005) report that 40-50% of restaurants fail over their first two years.}

Quality and reputation derive from two sources: investment by incumbent firms and replacement of exiting firms by new firms. Since learning does not affect reputation in expectation, equation (2) implies that the average reputation of incumbent firms changes at rate $\lambda(x - a)$, which is negative in steady state. This decline must be offset by replacement, which is the product of the replacement rate $\phi = -f(x^e)g(x^e)$ times the expected boost in reputation $\frac{1 - x^e}{2}$ when a new entrant with reputation $x \sim U[x^e, 1]$ replaces an exiting firm with reputation $x^e$. Rearranging, we can decompose average reputation into the investment and replacement effects

$$E[X] = E[A] + \frac{\phi \frac{1 - x^e}{2}}{\lambda}$$

(12)

where the expectation is taken with respect to the steady-state distribution $f$, and $A = a(X)$. In our simulation, the average reputation $E[X]$ is 0.74, with 52% coming from investment and 48% coming from replacement. Breaking down the latter term, the replacement rate equals $\phi = 0.18$, implying an approximate life expectancy of $1/\phi = 5.6$ years,\footnote{When calculating “approximate life expectancy” in the simulations we use the simple formula $1/\phi$. This technically assumes that exit is IID along a firm’s lifecycle.} while the average jump from replacement is 0.39.

### 3.5 Applications

Our model can help evaluate the impact of disclosure policies that aim to improve information in the marketplace. In the US, these policies started with the 1906 Pure Food and Drug Act and the 1933 Securities Exchange Act and have become increasingly popular as a form of “light touch”
Figure 1: **Equilibrium Simulation.** Panels A and C show a firm’s value and investment on path, where $x_t = z_t$. Panel B shows investment incentives as a function of reputation $x_t$ and self-esteem $z_t$. Panel D shows a typical firm lifecycle. Panels E and F show the steady-state distribution of firms’ reputation and exit times, assuming firms enter with reputation uniform on $[x^e, 1]$. We assume $k = 0.5$, $r = 0.2$, $c(a) = 0.2a^2$, $\bar{a} = 0.8$, $\lambda = 0.2$, and $\mu = 1$. 
regulation. For example, Jin and Leslie (2003, 2009) show that the introduction of restaurant health grades led to an increase in the quality of restaurants, especially for independent establishments. Similarly, Kolstad (2013) shows that the introduction of surgeon report cards prompted surgeons to improve the quality of their services. The model can also be used to assess the impact of third-party information providers that have a substantial impact of their respective industries, such as Moody’s (bonds), Tripadvisor (hotels), Edmunds (cars), Zillow (houses), and Greatschools (schools). For example, Luca (2016) shows that the introduction of Yelp pushed demand towards good restaurants and affected the selection of restaurants in the market.

Our paper provides a method to evaluate the impact of such changes. As a test case, recall the simulation in Section 3.4 and consider a 20% increase in the frequency of breakthroughs $\mu$ from 1 to 1.2. The increased monitoring reduces moral hazard, raising maximum firm value $V$ from 1.27 to 1.43; the higher option value then lowers the exit threshold $x^e$ from 0.22 to 0.18. Surprisingly, average reputation $E[X]$ rises only slightly, from 0.74 to 0.77. But the decomposition (12) tells a very different story. The faster learning boosts investment $E[A]$ from 0.38 to 0.48, while the exit rate $\phi$ drops from 0.18 to 0.14. Investment now accounts for 63% of the mean reputation, whereas replacement accounts for 37% (compared to 52%–48% before). In addition to showing how faster learning raises the importance of investment over replacement, it provides a cautionary tale about inferring investment from the steady-state reputation; we discuss how one can identify the model in Section 5.

The model is also useful to analyze other policies. For example, Luca and Luca (2018) find that minimum wages raise the exit rates of restaurants with low ratings on Yelp, but have no effect on highly rated restaurants. Minimum wages correspond to an increase in operating costs in our model which has a direct effect on selection by raising the exit threshold, and also an indirect effect on investment by lowering profits; the reduction in believed investment then hastens the decline in reputation between breakthroughs and further shortens life expectancy. For example, a 20% rise in operating cost $k$ from 0.5 to 0.6 lowers the maximum firm value $V$ from 1.27 to 0.68, and raises the exit threshold $x^e$ from 0.22 to 0.36. Again, the mean steady-state reputation is about the same (0.74 after vs. 0.75 before), but the mean investment is much smaller (0.19 vs. 0.38) and the exit rate is substantially higher (0.34 vs. 0.18). Investment now accounts for 25% of mean reputation, whereas replacement accounts for 75% (compared to 52%–48% in the benchmark).

4 Two Model Variants

In this section, we consider two natural variants of our baseline model; these help us understand the two economic forces underlying the single-peaked incentives seen in Theorem 1. In Section 4.1 we suppose the market observes the firm’s investment. Thus, both the firm and the market symmetrically learn about the firm’s quality, but there is no moral hazard. We show that investment decreases in the time since a breakthrough, as the firm approaches bankruptcy. In Section 4.2 we instead suppose the firm knows its own quality in addition to its investment, while the market knows neither. We show that investment increases in the time since a breakthrough, as the benefit from a breakthrough grows.

Fung, Graham, and Weil (2007) discuss over 130 rules that were introduced by the federal government over 1995-2005, such as policies disclosing the likelihood of a car rolling over, or the presence of toxic substances in workplaces.
4.1 Consumers Observe Firms’ Investment

Consider the baseline model and suppose that the market observes both the history of signals \( h^t \) and the firm’s past investment \( \{ a_s \}_{s \leq t} \). Since the market has the same information as the firm, reputation and self-esteem coincide \( x_t = z_t \); we can thus write firm value as a function of self-esteem alone. Analogous to equation (3), we truncate the firm’s flow payoffs at a breakthrough, yielding

\[
\hat{V}(z_t) = \sup_{a, \tau} \int_t^\tau e^{-\int_s^\tau r + \mu z_u du} \left[ z_a - c(a_s) - k + \mu z_a \hat{V}(1) \right] ds. \tag{13}
\]

Since the firm controls both self-esteem and reputation, the analysis of the equilibrium reduces to a decision problem. Write \( (\hat{a}, \hat{\tau}) \) for the optimal strategy and \( \hat{z} = \{ \hat{z}_t \} \) for the associated self-esteem.

The analysis follows Section 3. The value function is strictly convex with derivative\(^{16}\)

\[
\hat{V}'(z_t) = \hat{\Gamma}(t) := \int_t^\hat{\tau} e^{-\int_s^\tau r + \lambda + \mu (1 - \hat{z}_u) du} \left[ 1 + \mu (\hat{V}(1) - \hat{V}(\hat{z}_u)) \right] ds. \tag{14}
\]

In any optimal strategy, investment satisfies

\[
\lambda \hat{\Gamma}(t) = c'(\hat{a}_t)
\]

with \( \hat{a}_t = 0 \) if \( \lambda \hat{\Gamma}(t) < c'(0) \) and \( \hat{a}_t = \bar{a} \) if \( \lambda \hat{\Gamma}(t) > c'(\bar{a}) \).

**Theorem 3.** Investment \( \hat{a}_t \) decreases in the time since a breakthrough; at the exit threshold, \( \hat{a}_\hat{\tau} = 0 \). Moreover, the optimal exit time satisfies

\[
\hat{z}_\hat{\tau} - k + \mu \hat{z}_\hat{\tau} \hat{V}(1) = 0. \tag{15}
\]

**Proof.** Given assumption (4), drift \( g(a_t, z_t) \) is boundedly negative on \([z^\dagger, 1]\) and the firm exits before its reputation hits \( z^\dagger \). Since \( z_t \) decreases and the value function is strictly convex, \( \hat{\Gamma}(t) = \hat{V}'(z_t) \) strictly decreases in \( t \).

Intuitively, as the firm get closer to the exit time, any investment pays off over a shorter horizon, reducing incentives. When compared to the baseline model with moral hazard, investment directly raises reputation and hence revenue, in addition to raising self-esteem and the chance of future breakthroughs. This additional direct benefit of investment is captured by the additional “direct dividend” of “1” in (14), which is absent in (6). In the baseline model, investment initially increases over time, after a breakthrough, as the reputational dividends grow. Here we see incentives monotonically decrease over time, as the loss of direct dividends outweighs the growth of reputational dividends. This intuition also suggests that the elimination of moral hazard raises the level of investment and the exit time relative to the baseline model. In Appendix C.2 we verify this intuition for sufficiently large \( k \).

To illustrate the optimal strategy, we simulate it for the same parameters as the baseline model.\(^{17}\) The elimination of moral hazard raises the firm’s maximum value from 1.27 to 1.38.

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\(^{16}\)See Appendix C.1 for a proof. The subsequent analysis implies that \( V \) is indeed differentiable.

\(^{17}\)To simulate the equilibrium, we guess a post-breakthrough value \( \hat{V}(1) \) and use the exit condition (15) to derive \( x^e \). We then use the HJB to calculate values at each reputation, yielding a a post-breakthrough value \( \hat{V}(1) \). In equilibrium \( \hat{V}(1) \) and \( \hat{V}(1) \) coincide.
Figure 2: **Consumers Observe Firms’ Investment.** Panel A shows a firm’s investment. Panel B the steady-state distribution of firms’ reputation, assuming firms enter with reputation uniform on $[x_e, 1]$. Parameters are the same as Figure 1.

while lowering the exit threshold from 0.22 to 0.21. Panel A of Figure 2 shows that investment is increasing in reputation (see Theorem 3), and higher than investment in the baseline model (Figure 1, Panel C) at every level of reputation. Together with the lower exit threshold, the higher investment lowers the downward drift and extends the time to exit $\tau$ from 3.4 to 5.4 years. Panel B shows the steady-state distribution of revenue: The frequent breakthroughs and low downward reputational drift at the top skew the distribution of firms towards high levels of reputation. There is little entry so, in contrast to the baseline model, the density monotonically decreases as we approach the exit point.

We can understand the quantitative differences with the baseline model using the reputation decomposition (12). Average steady-state reputation is 0.87 with 89% coming from investment and 11% from replacement. Breaking down the replacement term, the exit rate drops to 0.04 (implying an approximate life expectancy of 22.5 years) while the average jump from replacement is 0.40. All told, the elimination of moral hazard substantially increases investment and also reduces the exit rate, both of which raise the importance of investment over replacement. These forces also account for the higher firm value, with the increase in life expectancy being more important for the average firm.\(^{18}\)

### 4.2 Firms Knows their Own Quality

Consider the baseline model and suppose the firm observes its own quality. As before, the market learns from public breakthroughs and maintains beliefs about the firm’s investment and quality. Crucially, the firm’s exit decision is now a signal of its quality since high-quality firms are more valuable and stay in business longer.

We focus on strategies that depend on the time since the last breakthrough, $t$, and on current

\(^{18}\)As a back of the envelope calculation, in the benchmark model the average value is approximately $E[x - k - c(a)]/(r + \phi) = 0.21/0.38 = 0.55$, where the “expectation” is the mean steady-state value. With observed investment, we have $E[x - k - c(a)]/(r + \phi) = 0.25/0.24 = 1.02$. Thus the majority in the increase in the “average firm value” comes from the increase in life expectancy.
quality. Thus, a recursive strategy consists of an investment plan \( a^\theta = \{a_t^\theta\} \) and an exit time \( \tau^\theta \) for \( \theta = L, H \). To analyze firm value for an arbitrary trajectory of reputation \( \{x_t\} \), we truncate its cash flow expansion at the first technology shock, obtaining

\[
V(t, \theta) = \sup_{a^\theta} \int_t^\infty e^{-(r+\lambda)(s-t)} \left[ x_s - c(a_s^\theta) - k + \lambda (a_s^\theta V(s, H) + (1-a_s^\theta) V(s, L)) + \mu \theta (V(0, H) - V(s, H)) \right] ds,
\]

where the last term captures the value of breakthroughs with present value \( V(0, 1) - V(s, 1) \) and arrival rate \( \mu \).

Writing \( \Delta(s) = V(s, H) - V(s, L) \) for the value of quality, optimal investment is thus characterized by the first-order condition

\[
\lambda \Delta(t) = c'(a_t^{\theta,*})
\]

with \( a_t^{\theta,*} = 0 \) if \( \lambda \Delta(t) < c'(0) \), and \( a_t^{\theta,*} = \bar{a} \) if \( \lambda \Delta(t) > c'(\bar{a}) \). Importantly, optimal investment is independent of the firm’s quality, allowing us to drop the “\( \theta \)” superscript. Intuitively, investment only pays off if there is a technology shock, in which case the firm’s current quality is irrelevant.

Equilibrium strategies \((a, \tau^\theta)\) and reputation \( \{x_t\} \) are defined as in Section 3.2. We restrict attention to equilibria where \( \{x_t\} \) is continuous and weakly decreasing.\(^{19}\)

**Theorem 4.** There exists an equilibrium with continuous and weakly decreasing reputation \( \{x_t\} \) and pure investment \( \{a_t^\theta\} \). In any such equilibrium the exit time of the low-quality firm \( \tau^L \) has support \([\tau, \infty)\) for some \( \tau > 0 \). Reputation and firm value are constant for \( t \in [\tau, \infty) \) and satisfy

\[
x_t - k + \max_a \{a \lambda V(t, H) - c(a)\} = 0.
\]

The high-quality firm never exits, i.e. \( \tau^H = \infty \). Investment \( a_t^\theta \) increases over \([0, \tau]\), and remains constant thereafter.

**Proof.** Exit behavior follows from Bar-Isaac (2003, Proposition 2). Low-quality firms start to exit at some time \( \tau^L \): If all low-quality firms exited at \( \tau^L \), reputation would jump to one, undermining equilibrium. Hence, low-quality firms randomize, exiting at a constant rate \( \psi \); this places a lower bound on reputation, allowing high-quality firms to stay in the market. See Appendix C.3 for details. Existence follows by the Kakutani-Fan-Glicksberg fixed point theorem, as shown in Appendix C.4.

We now show that investment increases over time. Since low-quality firm is indifferent at the exit threshold, it can achieve its value by remaining in the market indefinitely, thereby following the same strategy as the high-quality firm. Subtracting the value of high and low value firm (16), we obtain the following expression for the equilibrium value of quality

\[
\Delta(t) = V(t, H) - V(t, L) = \int_t^\infty e^{-(r+\lambda)(s-t)} \mu (V(0, H) - V(s, H)) ds.
\]

The integrand in (19) represents the *reputational dividend of quality*: high quality gives rise to future breakthroughs that arrive at rate \( \mu \) and boost the firm’s reputation to one; these dividends

\(^{19}\)The substantial part of this restriction is to rule out downward jumps in reputation. Indeed, for any \( t \), there exists an equilibrium where the firm exits at time \( t \) and failure to exit is punished by off-path market beliefs that quality is low, dropping revenue to zero and justifying the firm’s exit. We ignore such equilibria because it is implausible for the market to interpret failure to exit as a signal of low quality.
One may wonder how to bridge these starkly different predictions about investment behavior at the exit threshold. In Appendix C.5 we propose a model with imperfect private information that includes known and unknown quality as extreme cases. As with unknown quality, we argue that as long as private quality information is imperfect, investment is high and they are a long way from the exit threshold, whereas the average firm is better off in the known-quality model since the signaling effect of remaining in the market propels up firm value. Panel C shows a typical lifecycle: The firm’s reputation quickly hits the exit threshold ($x_e = 0.47$), where reputation is constant as the quitting of low-quality firms offsets the negative inference from lack of a breakthrough; it then obtains a sequence of breakthroughs before its reputation once again declines, and it eventually exits. At the threshold, low-quality firms exit at rate $\psi = 0.49$. From the market’s perspective, firms at $x_e$ exit at rate $(1 - x_e)\psi = 0.26$ and receive breakthroughs at rate $x_e\mu = 0.47$, and so remains at the exit threshold for 1.37 years. The overall exit rate multiplies the conditional exit rate $\psi$ with the number of low firms at the exit point, $\phi = (1 - x_e)\psi F(x_e) = 0.10$, implying an approximate life expectancy of 10 years. Finally, Panel D shows the steady-state distribution of firms’ reputations. Equation (11) implies that density is decreasing in reputation over $[x_e, 1]$ as a result of the breakthroughs; the zero drift at $x_e$ then results in a mass of firms at the exit threshold.

$\text{average values primarily result from the lower exit rate. As } s \in [0, \tau] \text{ rises, the firm’s value } V(s, 1) \text{ falls and reputational dividends } V(0, 1) - V(s, 1) \text{ grow. Hence an increase in } t \text{ leads to an increase in the value of quality (19), and in investment via the first-order condition (17).}$

Intuitively, breakthroughs are most valuable to a firm with low reputation since a breakthrough takes the firm from its current reputation to $x = 1$. These increasing investment incentives are in sharp contrast to the single-peaked, eventually-vanishing investment incentives in Theorem 1. In the baseline model, the firm gives up near the exit threshold and coasts into bankruptcy; with privately-known quality, the firm fights until the bitter end. Recall that with unknown quality, the firm’s investment at times $t \in [\tau^* - dt, \tau^*]$ pays off only if a technology shock arrives and a breakthrough arrives that averts exit. The probability of this joint event is of order $dt^2$, hence the expected gain eventually falls short of the investment costs. With known quality, only a technology shock is required for investment to pay off because the boost in quality is immediately observed by the firm, averting exit. Thus, investment incentives are of order $dt$ at all times, and are actually maximized when the firm is about to exit.\footnote{One may wonder how to bridge these starkly different predictions about investment behavior at the exit threshold. In Appendix C.5 we propose a model with imperfect private information that includes known and unknown quality as extreme cases. As with unknown quality, we argue that as long as private quality information is imperfect, investment vanishes at the exit threshold. However, the “invest until the better end” insight of the known quality variant is also robust in the sense that as the private information becomes perfect, the time interval over which investment vanishes shrinks to zero.}

To illustrate the equilibrium, Figure 3 simulates the model for the same parameters as in Figure 1.\footnote{To simulate the equilibrium, we guess a post-breakthrough value $V(0, H)$ and use the HJB and the exit condition (18), to derive exit threshold and the values at $x_e$. We then use the HJB to calculate values at each reputation, yielding a a post-breakthrough value $V(0, H)$. In equilibrium $V(0, H)$ and $\tilde{V}(0, H)$ coincide.} Panel A shows the value functions for the high- and low-quality firms; these are only defined on $[x^e, 1]$ since reputation never falls below $x_e = x_\tau$. Interestingly, the value after a breakthrough is lower in the baseline model (1.14 vs. 1.27), while the average steady-state value is somewhat higher (0.77 vs. 0.55).\footnote{These are back-of-the-envelope calculations. In the baseline model the average value is approximately $E[x - k - c(a)]/(r + \phi) = 0.21/0.38 = 0.55$. With known quality, we have $E[x - k - c(a)]/(r + \phi) = 0.23/0.29 = 0.77$, so higher average values primarily result from the lower exit rate.}

Intuitively, high-reputation firms are better off in the baseline model since investment is high and they are a long way from the exit threshold, whereas the average firm is better off in the known-quality model since the signaling effect of remaining in the market propels up firm value. Panel B shows that investment falls in reputation (see Theorem 3), and that investment at a given reputation is a little lower than in the baseline model. Panel C shows a typical lifecycle: The firm’s reputation quickly hits the exit threshold ($x_e = 0.47$), where reputation is constant as the quitting of low-quality firms offsets the negative inference from lack of a breakthrough; it then obtains a sequence of breakthroughs before its reputation once again declines, and it eventually exits. At the threshold, low-quality firms exit at rate $\psi = 0.49$. From the market’s perspective, firms at $x_e$ exit at rate $(1 - x_e)\psi = 0.26$ and receive breakthroughs at rate $x_e\mu = 0.47$, and so remains at the exit threshold for 1.37 years. The overall exit rate multiplies the conditional exit rate $\psi$ with the number of low firms at the exit point, $\phi = (1 - x_e)\psi F(x_e) = 0.10$, implying an approximate life expectancy of 10 years. Finally, Panel D shows the steady-state distribution of firms’ reputations. Equation (11) implies that density is decreasing in reputation over $[x_e, 1]$ as a result of the breakthroughs; the zero drift at $x_e$ then results in a mass of firms at the exit threshold.

$\text{In Appendix C.5 we propose a model with imperfect private information that includes known and unknown quality as extreme cases. As with unknown quality, we argue that as long as private quality information is imperfect, investment vanishes at the exit threshold. However, the “invest until the better end” insight of the known quality variant is also robust in the sense that as the private information becomes perfect, the time interval over which investment vanishes shrinks to zero.}$

$\text{To simulate the equilibrium, we guess a post-breakthrough value } V(0, H) \text{ and use the HJB and the exit condition (18), to derive exit threshold and the values at } x_e. \text{ We then use the HJB to calculate values at each reputation, yielding a a post-breakthrough value } V(0, H). \text{ In equilibrium } V(0, H) \text{ and } \tilde{V}(0, H) \text{ coincide.}$

$\text{These are back-of-the-envelope calculations. In the baseline model the average value is approximately } E[x - k - c(a)]/(r + \phi) = 0.21/0.38 = 0.55. \text{ With known quality, we have } E[x - k - c(a)]/(r + \phi) = 0.23/0.29 = 0.77, \text{ so higher average values primarily result from the lower exit rate.}$
Figure 3: Firms Know their Quality. Panels A and B show a firm's value and investment. Panel C shows a typical firm lifecycle. Panel D shows the steady-state distribution of firms' reputation, assuming firms enter with reputation uniform on $[x_e, 1]$. Parameters are the same as Figure 1.

We can understand the quantitative differences with the benchmark model by decomposing average reputation. Relative to equation (12), there is now a third term (the “signaling effect”) supporting the firm’s reputation. Since low-quality firms at the exit threshold exit at rate $\psi$, failure to exit is good news; this induces an upward drift of $\psi x^e(1 - x^e)$ on the $F(x^e)$ firms at the cutoff. All told,

$$E[X] = E[A] + \frac{\phi}{\lambda} \frac{1 - x^e}{2} + \frac{\psi}{\lambda} x^e(1 - x^e)F(x^e).$$

In Figure 3, the average steady-state reputation is 0.75 with 49% coming from investment, 17% from replacement, and 34% coming from signaling.

5 Discussion
We have proposed a model in which firms make optimal investment and exit decisions, while the market learns about the quality of the firm’s product. We characterize investment incentives and
show they are single-peaked in the firm’s reputation. This yields predictions about the distribution of firms’ reputation and turnover rate. The model follows the spirit of Ericson and Pakes (1995), and we hope that it can be used as a framework for empirical work. For example, it could be used to study the rise and fall of new restaurants, or the incentives for surgeons to invest in their skills.

To illustrate how to identify the model parameters, suppose we observed data generated by the baseline model. Given a time series of $x_t$ (e.g., revenue or reputation data), one can identify $\mu$ from the frequency of jumps, $\lambda$ from the drift at $x^e$, and on-path investment $a(x)$ via the drift of $x_t$ elsewhere. Calibrating the interest rate, one can then uniquely identify the operating cost $k$ from the exit condition (8) and the investment cost function $c(\cdot)$ from the first-order condition (7). See Appendix C.6 for details. Alternatively, one could use accounting data to shed light on costs, or aggregate data like the distribution of firms’ reputations and the distribution of exit rates.

Depending on the application, the model can be made more realistic in a variety of ways. First, while we assume revenue equals reputation $x_t$, the analysis in Section 3 generalizes immediately to any increasing function of reputation $\pi(x_t)$. One could also assume the firm cares about its self-esteem directly, as in Kolstad (2013). Second, while our firms operate independently, one can introduce product market competition and entry decisions as in Jovanovic (1982) or Hopenhayn (1992). For the entry decision, the simplest assumption is that firms pay a fixed entry cost and then receive a random draw of reputation; the entry condition then uniquely pins down equilibrium prices. Alternatively, firms may have information about their entry costs or reputation when deciding to enter (e.g., surgeons entering a profession with different levels of education). For the product market competition, one can follow Atkeson, Hellwig, and Ordoñez (2014) by assuming that price is determined by aggregate quality $p_t = p(\int x_{t,i} d\delta_i)$, and the revenue of firm $i$ by $p_t x_{t,i}$. Alternatively, one could model an oligopoly by assuming firm $i$ obtains reduced-form profits $\pi(x_i, x_{-i})$. The former approach has the advantage that, in steady state, the price is a sufficient statistic for all other firms, whereas in an oligopoly one must keep track of each firm’s reputation and self-esteem. Third, to avoid the stark prediction of a deterministic exit threshold, one could introduce heterogeneity in operating costs. These can be identified off the distribution of exiting reputations or revenues. Fourth, while our firms have fixed production capacity of one unit, one could allow firms to choose their operating scale as in Zhao (2016), or endow them with regular capital as well as reputational capital, bridging our model with Ericson and Pakes (1995).

Perhaps the biggest concern when bringing the model to data is the overly stylized perfect good news learning. The qualitative nature of investment incentives generalize to imperfect-good-news Poisson and Brownian learning models, so if one identifies the model from aggregate data (e.g., distribution of firms’ reputations and exit rates), then this may not be a bad assumption. However, given time-series data on reputation or revenue, one may wish to use a more continuous model of learning. For example, suppose the market observes Brownian signals of quality $d\xi_t = \mu_B \theta_t + dW_t$. In such competitive models one could also allow for types to be correlated. This means that a success for one firm (e.g., positive reviews of a brand of electric car) may benefit all firms in the industry.

$^{24}$It is hard to formally show incentives are single-peaked under imperfect news structures, but it is still the case that incentives are low when updating is slow ($x \approx 1$) and vanish when the expected lifespan is short ($x \approx x^e$). The situation is different with bad-news Poisson learning where an agent with reputation $x \approx x^e$ drifts up and may not have a short life expectancy.
A firm’s reputation and self-esteem evolve according to

\[ dx_t = g(a_t, x_t, z_t)dt + \sigma(x_t)dW_t \]
\[ dz_t = g(a_t, z_t, \tilde{z}_t)dt + \sigma(z_t)dW_t \]

with drift \( g(a, x, z) = \lambda(a - x) + \mu_B x(1 - x)(z - x) \) and variance \( \sigma(x) = \mu_B x(1 - x) \). Given Markovian strategy \( a(x, z) \) and belief \( \tilde{a}(x, z) \), the value function is determined by:

\[
rV(x, z) = [x - k - c(a)] + g(z, z, a)V_z(x, z) + g(x, z, \tilde{a})V_x(x, z) \\
+ \frac{1}{2} \sigma(z)^2 V_{xx}(x, z) + \frac{1}{2} \sigma(z)^2 V_{zz}(x, z) + \sigma(x)\sigma(z)V_{xz}(x, z)
\]

Optimal investment satisfies the usual first-order condition, \( c'(a(x, z)) = \lambda V_z(x, z) \), while equilibrium beliefs are given by \( \tilde{a}(x) = a(x, x) \). As with the perfect good news model, one can then back out the parameters from data. Given a time series of \( x_t \), one can then identify \( \mu_B \) from the variance of \( x_t \), \( \lambda \) from the drift at \( x^e \), and equilibrium effort \( a(x) \) from the drift of \( x_t \) elsewhere. We conjecture that, as before, the marginal cost can be derived from the first-order condition, and the operating cost from the exit condition, \( x^e - k + \frac{1}{2}\sigma^2(x)V_{xx}(x^e, x^e) = 0 \). One can alternatively assume a Poisson signal structure. Ultimately, the appropriate model depends on the news structure that is generating the data, and the policies one wishes to investigate. For example, with a Poisson model one can ask whether the government should give awards to the best surgeon (adding good news signals) or flag the worst (adding bad news signals).
Appendix

A Proofs from Section 3.1

A.1 Monotonicity of Value Function in Section 3.1

**Lemma 3.** If \( \{x_t\} \) strictly decreases, then \( V(t, z) \) strictly decreases in \( t \) and strictly increases in \( z \) on \( \{(t, z) : V(t, z) > 0\} \).

**Proof.** Fix \( t \geq t' \) and \( z \leq z' \) and consider a ‘low’ firm with initial state \((t, z)\) and a ‘high’ firm with initial state \((t', z')\). We can represent the firms’ strategies as an increasing sequence of potential breakthrough times \( \{t_i\}_{i \in \mathbb{N}} \) that follow a Poisson distribution with parameter \( \lambda \), and a sequence of uniform \([0, 1]\) random variables \( \{\zeta_i\}_{i \in \mathbb{N}} \), with the interpretation that the firm experiences an actual breakthrough after time \( \sigma \) (that is at time \( t + \sigma \) for the ‘low’ firm and at time \( t' + \sigma \) for the ‘high’ firm) if \( \sigma = t_i \) for some \( i \) and \( \zeta_i \leq Z_{i-} \). Fixing any realization of uncertainty \( \{t_i, \zeta_i\}_{i \in \mathbb{N}} \), let \( (\{A^*_\sigma\}, T^*) \) be the ‘low’ firm’s optimal strategy given this realization, and assume that the ‘high’ firm mimics this strategy; note that this strategy is in general not recursive for the ‘high’ firm. Given \( \{t_i, \zeta_i\} \) and \( (\{A^*_\sigma\}, T^*) \), we can compute revenue and self-esteem of the ‘low’ and ‘high’ firms \( (X_\sigma, Z_\sigma) \) and \( (X'_\sigma, Z'_\sigma) \), respectively, for any \( \sigma \geq 0 \). We now argue inductively that

\[
X_\sigma \leq X'_\sigma \quad \text{and} \quad Z_\sigma \leq Z'_\sigma
\]

for any \( \sigma < t_i \) and any \( i \in \mathbb{N} \). For \( i = 1 \) (\( \sigma \in [0, t_1) \)) we have \( X_\sigma = x_{t+\sigma} < x_{t'+\sigma} = X'_\sigma \) because \( \{x_t\} \) decreases, and the self-esteem trajectories \( Z_\sigma, Z'_\sigma \) are governed by the ODE \( \dot{z} = g(a, z) \), implying (20) for \( \sigma \in [0, t_1) \). At \( \sigma = t_1 \), the ‘low’ (resp ‘high’) firm experiences a breakthrough if \( \zeta_1 \leq Z_{1-} \) (resp \( \zeta_1 \leq Z'_{1-} \)). As \( Z_{1-} \leq Z'_{1-} \), we get (20) for \( \sigma = t_1 \). Inductive application of these steps yields (20) for all \( \sigma \). Thus by mimicking the ‘low’ firm’s optimal strategy \( (\{A^*_\sigma\}, T^*) \) for any realization \( \{t_i, \zeta_i\} \), the ‘high’ firm can guarantee itself weakly higher cash-flows \( X'_\sigma - cA^*_\sigma - k \) at all times \( \sigma \), implying \( V(t', z') \geq V(t, z) \). As long as firm value is strictly positive and the firms don’t exit immediately, the inequality \( X_\sigma \leq X'_\sigma \) is strict for a positive measure of times with positive probability, implying \( V(t', z') > V(t, z) \). \( \square \)

A.2 Proof of Lemma 1

Fix time \( t \), self-esteem \( z_t \), firm strategy \( (a, \tau) \) (not necessarily optimal), write \( z = \{z_s\}_{s \geq t} \) for future self-esteem, and let

\[
\Pi(t, z_t) = \int_{s=t}^T e^{-\int_s^t r + \mu z_u du} (x_s - c(a_s) - k + \mu z_s \Pi(0, 1)) ds
\]

be the firm’s continuation value, where the integral of the cash-flows is truncated at the first breakthrough as in (3). We will show that \( \Pi(t, z) \) is differentiable in \( z \) with derivative

\[
\Pi_z(t, z_t) = \int_{s=t}^T e^{-\int_s^t r + \lambda + \mu(1-z_u) du} \mu(\Pi(0, 1) - \Pi(s, z_s)) ds.
\]

Equation (6) then follows by the envelope theorem, Milgrom and Segal (2002), Theorem 1.
To show (22) we first recall two facts from Board and Meyer-ter-Vehn (2013).

Claim 1: For any bounded, measurable functions \( \phi, \rho : [0, \tau] \rightarrow \mathbb{R} \), the function

\[
\psi(t) = \int_t^\tau e^{-\int_u^t \rho(u)du} \phi(s)ds
\]

is the unique solution to the integral equation

\[
f(t) = \int_{s=t}^\tau (\phi(s) - \rho(s)f(s))ds.
\]

This is proved for \( \tau = \infty \) and constant \( \rho \) in Board and Meyer-ter-Vehn (2013, Lemma 5). The proof generalizes immediately to finite \( \tau \) and measurable functions \( \rho(t) \).

Claim 2: For any times \( s > t \) and fixed investment \( a \), time-\( s \) self-esteem \( z_s \) is differentiable in time-\( t \) self-esteem \( z_t \). The derivative is

\[
\frac{dz_s}{dz_t} = \exp \left( -\int_{u=t}^s (\lambda + \mu(1 - 2z_u))du \right).
\]

This follows by the same arguments as in Board and Meyer-ter-Vehn (2013, Lemma 8b).

Setting \( \psi(s) = e^{-r(s-t)}\Pi(s,z_s), \rho(s) = \mu z_s \) and \( \phi(s) = e^{-r(s-t)}(x_s - c(a_s) - k + \mu z_s \Pi(0,1)) \), equation (21) becomes (23). Applying Claim 1, we get (24) which becomes

\[
\Pi(t, z_t) = \int_{s=t}^\tau e^{-r(s-t)}(x_s - c(a_s) - k + \mu z_s (\Pi(0,1) - \Pi(s, z_s)))ds.
\]

Taking the derivative with respect to \( z \) at \( z = z_t \) and applying Claim 2, we get

\[
\Pi_z(t, z_t) = \int_{s=t}^\tau e^{-r(s-t)}\frac{dz_s}{dz_t} \left( \mu(\Pi(0,1) - \Pi(s, z_s)) - \mu z_s \Pi_z(s, z_s) \right)ds.
\]

Setting \( \rho(s) = \mu z_s, \phi(s) = e^{-\int_a^s r + \lambda + \mu(1 - 2z_u)du} \mu(\Pi(0,1) - \Pi(t, z_s)) \), and \( f(s) = e^{-\int_a^s r + \lambda + \mu(1 - 2z_u)du} \Pi_z(s, z_s) \), the previous equation becomes (24). Applying Claim 1, we get (23) which becomes

\[
\Pi_z(t, z_t) = \int_t^\tau e^{-\int_s^t \mu z_u du} e^{-\int_a^s r + \lambda + \mu(1 - 2z_u)du} \mu(\Pi(0,1) - \Pi(t, z_s))ds,
\]

implying (22).
A.3 Differentiability in Proof of Theorem 1

This appendix relaxes the assumption that value functions are differentiable in the proof of Theorem 1. We first establish that whenever the partial derivative $V_t(t, z^*_t)$ exists, it is equal to

$$\Psi(t) := \int_t^{\tau^*} e^{-\int_t^r r + \mu z^*_s \, du} \, dx_s. \quad (25)$$

Moreover, $\Psi(t) < 0$ for $t < \tau^*$.

Rewrite the firm’s continuation value (3) by writing $\sigma = s - t$ for the time since $t$ and $\{a^*_\sigma, \zeta^*\}$ for the optimal strategy starting at $t$. Then, $V(t, z^*_t) = \int_\sigma^{\tau^*} e^{-\int_\sigma^r (r + \mu z^*_{s+\sigma}) \, du} (x_{t+\sigma} - k - c(a^*_\sigma) + \mu z^*_{t+\sigma} V(0, 1)) \, d\sigma.$

As $z^*_{t+\sigma}$ is determined by initial self-esteem $z^*_t$ and $\{a^*_\sigma\}$, it is independent of $t$. The envelope theorem thus yields (25). As $\{x_t\}$ strictly decreases, $dx_s < 0$ and hence $\Psi(t)$ must be negative.

Next, the discount rate $\rho(t) = r + \lambda + \mu(1 - z^*_t)$ is Lipschitz-continuous, with derivative $\mu \dot{z}^*_t$ where $\dot{z}^*_t = g(a^*_t, z^*_t) = \lambda(a^*_t - z^*_t) - \mu z^*_t(1 - z^*_t)$ for almost all $t$. Firm value as a function of time $t \mapsto V(t, z^*_t)$ is also Lipschitz continuous with derivative $\frac{d}{dt} V(t, z^*_t) = \dot{\Gamma}(t) + \dot{z}^*_t \Gamma(t)$ for almost all $t$.

Now assume that $\dot{\Gamma}(t) \leq 0$. Then

$$\dot{\Gamma}(t + \varepsilon) - \dot{\Gamma}(t) = \int_t^{t+\varepsilon} \frac{d}{ds} \left[ \rho(s) \Gamma(s) - \mu(V(0, 1) - V(s, z^*_s)) \right] \, ds$$

$$= \int_t^{t+\varepsilon} \left[ \rho(s) \dot{\Gamma}(s) + \rho(s) \Gamma(s) + \mu \frac{d}{ds} V(s, z^*_s) \right] \, ds$$

$$= \int_t^{t+\varepsilon} \left[ \rho(s) \dot{\Gamma}(s) - \mu \dot{z}^*_s \Gamma(s) + \mu \dot{z}^*_s \Gamma(s) \right] \, ds$$

$$= \int_t^{t+\varepsilon} \rho(s) \dot{\Gamma}(s) + \mu \dot{\Gamma}(s) \, ds.$$  

Since $\Psi(s) < 0$, $\dot{\Gamma}(t) \leq 0$, and $\rho(s)$ and $\dot{\Gamma}(s)$ are continuous, the integrand is strictly negative for small $\varepsilon$, so $\dot{\Gamma}$ strictly decreases on some small interval $[t, t + \varepsilon]$. If $\Gamma$ did not strictly decrease on $[t, \tau^*]$ there would exist $t' > t$ with $\dot{\Gamma}(t') < 0$ and $\dot{\Gamma}(t' + \varepsilon) \geq \dot{\Gamma}(t')$ for arbitrarily small $\varepsilon$, which is impossible by the above argument.

B Mixed Strategies and Existence

Here we show that equilibrium exists (Section B.1), and describe how mixed strategy equilibria differ from the pure strategy equilibria studied in the body of the paper (Section B.2).

B.1 Proof of Theorem 2

Preliminaries: We first define mixed (recursive) strategies. Write mixed beliefs as distributions over pure beliefs $F = F(\tilde{a}, \tilde{\pi})$. Let $\tau(F) := \min \{ t : F(\tilde{\tau} \leq t) = 1 \}$ be the first time at which the market expects the firm to exit with certainty. Writing $\mathbb{E}^F$ for expectations under $F$, the firm’s reputation
is given by \( x_t = \mathbb{E}^F[\theta_t h^t, \tilde{\tau} > t] \) for all \( t < \tau(F) \). Since breakthroughs arrive with intensity \( \mu z_s(\tilde{a}) \), the probability of no breakthrough before time \( t \) equals \( w_t(\tilde{a}) := \exp(-\mu \int_0^t z_s(\tilde{a}) ds) \). Bayes’ rule then implies

\[
x_t = \frac{\mathbb{E}^F[z_t(\tilde{a}) w_t(\tilde{a}) \mathbb{I}_{t<\tau}]}{\mathbb{E}^F[w_t(\tilde{a}) \mathbb{I}_{t<\tau}]}, \quad t < \tau(F).
\]

When the firm fails to exit, that is at times \( t \geq \tau(F) \), the market revises its beliefs about the firm’s strategy to some arbitrary \( F'(\tilde{a}, \tau) \) with \( t < \tau(F') \) and reputation equals \( x_t = \mathbb{E}^F[\theta_t h^t, \tilde{\tau} > t] \).

An equilibrium consists of a distribution over recursive investment and exit strategies \( F = F(a, \tau) \) and a recursive revenue trajectory \( x = \{x_t\} \) such that:

(a) Given \( \{x_t\} \), any strategy \((a, \tau)\) in the support of \( F \) solves the firm’s problem (3).

(b) Reputation \( \{x_t\} \) is derived from \( F \) by Bayes’s rule via (26) for \( t < \tau(F) \).

Proof strategy: The firm’s payoff from strategy \((a, \tau)\) is given by

\[
\Pi(a, \tau; x) = \frac{\int_0^{\tau} e^{-\int_{\xi=0}^t r + \mu z_s ds} (x_t - ca_t - k) dt}{1 - \int_0^{\tau} e^{-\int_{\xi=0}^t r + \mu z_s ds} \mu z_t dt}
\]

The proof idea is to show that the firm’s best-response correspondence

\[
BR(x) = \arg \max_{a, \tau} \Pi(a, \tau; x)
\]

and the Bayesian updating formula \( \mathcal{B} \) defined by (26) admit a fixed point.

To establish existence of a fixed point we define topologies on the space of mixed strategies \( F \) and reputation trajectories \( \{x_t\} \) with the property that both spaces are compact, locally convex, and Hausdorff, and both correspondences are upper-hemicontinuous. Then the existence of the fixed point follows by the Kakutani-Fan-Glicksberg theorem.

Defining the topological spaces: By (4) the firm’s optimal exit time is bounded above by some finite \( \tilde{\tau} \), allowing us to truncate the domain of all pertinent functions at \( \tilde{\tau} \). So motivated, embed the space \( B \) of measurable, bounded functions \([0, \tilde{\tau}] \mapsto [0, 1] \) in the (rescaled) unit ball of \( L^2([0, \tilde{\tau}], \mathbb{R}) \).

We interpret both investment \( \{a_t\} \) and reputation \( \{x_t\} \) as elements of \( B \). In the weak topology this unit ball is compact by Alaoglu’s theorem, and as a closed subset of this unit ball, \( B \) is also compact. In this topology a sequence \( \{a^n_t\} \) converges to \( \{a_t\} \) if \( \int_0^{\tilde{\tau}} (a^n_t - a_t) \xi_t dt \to 0 \) for all test functions \( \xi \in L^2([0, \tilde{\tau}], \mathbb{R}) \). This topology is coarse enough to make \( B \) compact, but also fine enough for the trajectory \( \{z_t\}_{t \in [0, \tilde{\tau}]} \) to be continuous (in the sup-norm) in \( \{a_t\}_{t \in [0, \tilde{\tau}]} \) (see Theorem 43.5 of Davis (1993)). Thus, firm value (3) is continuous in \( \{(a_t), \{x_t\}, \tau\} \) and is maximized by some \( \{(a^*_t), \tau^*\} \).

As for the firm’s mixed strategies, we equip \( \Delta(B \times [0, \tilde{\tau}]) \) with the topology of convergence in distribution. Standard arguments (e.g. Theorem 14.11 of Aliprantis and Border (1999)) show that this space is compact and locally convex.

Upper hemicontinuity of Bayes’ rule: We now prove that the correspondence \( \mathcal{B} : \Delta(B \times [0, \tilde{\tau}]) \to B \) mapping beliefs \( F \) to the set of measurable trajectories \( \{x_t\} \) that satisfy (26) for \( t < \tau(F) \) is upper hemicontinuous. Consider a sequence of beliefs \( F^n \) (with expectation \( \mathbb{E}^n \)) that converges to \( F \) in distribution. \( \mathcal{B}(F^n) \) consists of all measurable trajectories \( \{x^n_t\} \) that satisfy (26) (when replacing
\(E^F\) by \(E^n\) for \(t < \tau(F^n)\). As \(F\) assigns probability less than one to the event \(\{\bar{\tau} < t\}\) for any \(t < \tau(F)\), so does \(F^n\) for sufficiently large \(n\); thus, \(\lim_{n \to \infty} \tau(F^n) \geq \tau(F)\).

We now show that \(x^0_t \to x_t\) for all \(t < \tau(F)\) at which the marginal distribution \(F(\bar{\tau})\) is continuous.\(^{25}\) Consider the numerator of (26) (the argument for the denominator is identical). The integrand \(\chi^+_t(\hat{a}, \bar{\tau}) := z_t(\hat{a})w_t(\hat{a})I_{\{\bar{\tau} \geq t\}}\) is continuous in \(\hat{a}\) (see, Theorem 43.5 of Davis (1993)) and lower semi-continuous in \(\bar{\tau}\); similarly, \(\chi^-_t(\hat{a}, \bar{\tau}) := z_t(\hat{a})w_t(\hat{a})I_{\{\bar{\tau} > t\}}\) is continuous in \(\hat{a}\) and upper semi-continuous in \(\bar{\tau}\). The portmanteau theorem thus implies \(\liminf E^n[\chi^-_t(\hat{a}, \bar{\tau})] \geq \limsup E^n[\chi^+_t(\hat{a}, \bar{\tau})]\) and \(E^F[\chi^+_t(\hat{a}, \bar{\tau})] \geq \limsup E^n[\chi^+_t(\hat{a}, \bar{\tau})]\). As \(\chi^-_t\) and \(\chi^+_t\) are bounded and disagree only for \(\bar{\tau} = t\), which happens with probability zero under \(F\) and thus with vanishing probability under \(F^n\), we have \(E^F[\chi^-_t(\hat{a}, \bar{\tau})] = E^F[\chi^+_t(\hat{a}, \bar{\tau})]\) and \(\limsup E^n[\chi^+_t(\hat{a}, \bar{\tau})] = \limsup E^n[\chi^-_t(\hat{a}, \bar{\tau})]\). Thus,

\[
\liminf E^n[\chi^-_t(\hat{a}, \bar{\tau})] \geq \limsup E^n[\chi^+_t(\hat{a}, \bar{\tau})] \geq \limsup E^n[\chi^+_t(\hat{a}, \bar{\tau})]
\]

and so \(\lim E^n[\chi^-_t(\hat{a}, \bar{\tau})]\) exists and equals \(\limsup E^n[\chi^+_t(\hat{a}, \bar{\tau})]\) as desired. Thus \(\{x^0_t\}\) converges to \(\{x_t\}\) pointwise for almost all \(t \in [0, \tau(F)]\), and therefore in the \(L^2([0, \tau(F)], [0, 1])\)-norm and a fortiori in the weak topology. As the set \(B(F)\) allows for any measurable trajectories after \(\tau(F)\), all trajectories \(\{x^0_t\}_{t \in [0, \tau]} \in B(F^n)\) are uniformly close to \(B(F)\); that is, \(B\) is upper hemicontinuous.

**Upper hemicontinuity of the firm’s best responses:** Self-esteem \(z_t\) is continuous in \(a \in B\), so the firm’s payoff \(\Pi(a, \tau; x)\) is continuous in \(a, \tau\) and \(x\), and thus also continuous in \(F = F(a, \tau)\) (Theorem 14.5 of Aliprantis and Border (1999)); thus Berge’s maximum theorem implies that the best response mapping \(BR : B \to \Delta(B \times [0, \tau])\) is upper hemicontinuous.

**Summary:** We have shown that \((x, F) \mapsto (B(F), BR(x))\) is an upper hemicontinuous, convex-valued mapping of the compact, locally convex, Hausdorff space \(B \times \Delta(B \times [0, \tau])\) to itself. The Kakutani-Fan-Glicksberg theorem therefore implies that this mapping has a fixed point; this fixed point constitutes an equilibrium.

### B.2 Mixed-Strategy Equilibrium: An Illustration

The model may potentially exhibit mixed-strategy equilibria. This section discusses possible features of such an equilibrium, as illustrated in Figure 4.\(^{26}\) For simplicity, assume that investment costs are linear, \(c(a_t) = ca_t\), so that optimal investment \(a_t^*\) is either \(\hat{a}\) (work) or 0 (shirk). In this picture, the work region is the area above some function \(z(t)\). There are then two optimal trajectories of self-esteem for the firm: the ‘low’ path is full-shirk, while the ‘high’ path is shirk-work-shirk. The dynamic complementarity of investment means that the firm that works when the paths divide then strictly prefers to continue working, while the firm that shirks at the dividing line then strictly prefers to continue shirking. The firm’s reputation, which equals the market’s belief about the firm’s self-esteem, is sandwiched between these two trajectories of self-esteem.

When both firms remain in the market, reputation and self-esteem decline as normal. After sufficient time without a breakthrough, the ‘low’ firm wishes to exit. If the firm was believed to exit deterministically at some time \(\tau\), reputation would jump up at \(\tau\), undermining incentives to actually exit. Thus, equilibrium requires that the ‘low’ firm randomizes between exiting and

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\(^{25}\) It can have at most countably many discontinuities.

\(^{26}\) This is an illustration of a mixed equilibrium; we have not been able to construct one.
removing in the market over some period $[\tau, \bar{\tau}]$. During this exit period, self-esteem declines, and so reputation has to rise so as to satisfy the firm’s optimal exit condition (8). Once the ‘low’ firm has exited with probability one, reputation coincides with the self-esteem of the ‘high’ firm. Such a firm exits deterministically when its self-esteem has fallen sufficiently. Since reputation increases at some times prior to exit, we can no longer conclude that investment incentives are single-peaked. However, equation (6) implies that the ‘high’ firm shirks near the exit time.

C Proofs from Section 4

C.1 Derivation of Equation (14)

This proof is analogous to the proof of Lemma 1, given in Appendix A.2. With observable investment, the firm’s payoff from strategy $(a, \tau)$ is given by

$$\hat{\Pi}(z_t) = \int_{s=t}^\tau e^{-\int_s^\tau r + \mu z_s du} (z_s - c(a_s) - k + \mu z_s \hat{\Pi}(1)) ds.$$ 

Setting $\psi(s) = e^{-r(s-t)}\hat{\Pi}(z_s)$, $\rho(s) = \mu z_s$ and $\phi(s) = e^{-r(s-t)}(z_s - c(a_s) - k + \mu z_s \hat{\Pi}(1))$ yields equation (23). Applying Claim 1, equation (24) becomes

$$\hat{\Pi}(z_t) = \int_{s=t}^\tau e^{-r(s-t)}(z_s - c(a_s) - k + \mu z_s (\hat{\Pi}(1) - \hat{\Pi}(z_s))) ds.$$ 

Taking the derivative and applying Claim 2 we get

$$\hat{\Pi}'(z_t) = \int_{s=t}^\tau e^{-r(s-t)} \frac{dz_s}{dz_t} (1 + \mu (\hat{\Pi}(1) - \hat{\Pi}(z_s)) - \mu z_s \hat{\Pi}'(z_s)) ds$$

$$= \int_{s=t}^\tau e^{-\int_s^\tau r + \lambda + \mu(1-2z_s) du} (1 + \mu (\hat{\Pi}(1) - \hat{\Pi}(z_s)) - \mu z_s \hat{\Pi}'(z_s)) ds.$$
Setting $\rho(s) = \mu z_s$ and $\phi(s) = e^{-\int_{t}^{s} r + \lambda + \mu(1-2z_u) du} \mu(\bar{\Pi}(1) - \bar{\Pi}(z_s))$, $f(s) = e^{-\int_{t}^{s} r + \lambda + \mu(1-2z_u) du} \bar{\Pi}'(z_s)$ satisfies (24). Applying Claim 1, equation (23) becomes

$$\bar{\Pi}'(z_t) = \int_{s=t}^{T} e^{-\int_{s}^{t} r + \lambda + \mu(1-2z_u) du} \mu(1 + \bar{\Pi}(1) - \bar{\Pi}(z_s)) ds.$$  

The envelope theorem then implies equation (14).

### C.2 Observability Raises Investment

Here we argue that, when $k$ is sufficiently large, investment and exit time are higher under observable investment, $\hat{a}_t > a_t^*$ and $\hat{\tau} > \tau^*$.

First, dropping the positive terms $\mu(\hat{V}(1) - \hat{V}(\hat{z}_s))$ in the integrand and $\mu \hat{z}_u$ in the exponent of (14) implies $\hat{\Gamma}(\hat{\tau} - s) > \frac{1 - e^{-(r + \lambda + \mu)s}}{r + \lambda + \mu}$. Similarly, dropping the negative $-\mu(1 - \hat{z}_u)$ in the exponent in (6), and bounding the integrand above by $V(0, 1) - V(s, z^*_s) < V(0, 1) < (1 - k)/r$ implies $\frac{1 - k}{r} \frac{1 - e^{-(r + \lambda)s}}{r + \lambda} > \Gamma^*(\tau^* - s)$. Then, for $k$ close to 1, $\hat{\Gamma}(\hat{\tau} - s) > \Gamma^*(\tau^* - s)$ and so $\hat{a}_{\hat{\tau} - s} > a_{\tau - s}^*$.

Next, observe that $\hat{V}(1) > V^*(0, 1)$, so the exit conditions (8) and (15) imply $\hat{z}_\hat{\tau} < z^*_\hat{\tau}$. Together with $\hat{a}_{\hat{\tau} - s} > a_{\tau - s}^*$ and $\hat{z}_0 = z^*_0$, this implies $\hat{\tau} > \tau^*$. Since observable investment falls over time, we conclude that $\hat{a}_{\hat{\tau} - s} > \hat{a}_{\hat{\tau} - s} > a_{\tau - s}^*$, and hence $\hat{a}_t > a_t^*$ for all $t = \tau^* - s$.

Investment is also higher at a given level of reputation $x = z$. Indeed, $\hat{a}_{\hat{\tau} - s} > a_{\tau - s}^*$ together with $\hat{z}_\hat{\tau} < z^*_\hat{\tau}$ imply $\hat{z}_{\hat{\tau} - s} < z^*_{\hat{\tau} - s}$, so defining $s' < s$ via $\hat{z}_{\hat{\tau} - s'} = z^*_{\hat{\tau} - s'} = z$, investment at $z$ is higher when investment is observable since $\hat{a}(z, z) := \hat{a}_{\hat{\tau} - s'} > \hat{a}_{\hat{\tau} - s} > a_{\tau - s}^* =: a^*(z, z)$.

### C.3 Exit Behavior in Theorem 4

Here we establish that a low-quality firm exits at time $\tau^L \in [\underline{\tau}, \infty)$, while the high-quality firm never exits.

Reputation $\{x_t\}$ continuously decreases, and so firm value

$$V(t, \theta) = \sup_{a, \tau^L} \int_{t}^{\tau^L} e^{-(r + \lambda + \mu\theta)(s-t)} [x_s - c(s) - k + \lambda(a_s V(s, H) + (1 - a_s)V(s, L)) + \mu \theta V(0, \theta)] ds$$

continuously decreases, too. For an optimal investment strategy $a^*$, the above integrand continuously decreases in $t$ as well. Thus, exiting is optimal exactly when the integrand vanishes; since $V(\tau^L, L) = 0$, flow payoffs of the low-quality firm are given by (18). As the integrand for the high-quality firm exceeds the integrand of the low-quality firm, the latest possible exit time of the low-quality firm must strictly precede the earliest possible exit time of the high-quality firm.

To see that the low-quality firm starts exiting at some finite $\underline{\tau}$, recall the upper bound on equilibrium exit times $\bar{\tau}$ from the proof of Theorem 2. Unless the market expects the low-quality firm to start exiting and draws a positive inference from its failure to exit, reputational drift $g(\bar{a}, x) \leq g(a, x)$ is strictly negative on $[x^\dagger, 1]$ and takes reputation below $x^\dagger$ at or before $\bar{\tau}$. Thus, in equilibrium the low-quality firm must eventually exit, and we define $\overline{\tau}$ as the earliest time at which it does so.

After $\underline{\tau}$ reputation must be constant. Otherwise, if it started to decrease at some time $t > \underline{\tau}$, the flow payoffs of the low-quality firm turn strictly negative and the low-quality firm would exit with certainty; thus reputation would jump to one, undermining incentives to exit. Therefore, the firm’s
problem becomes stationary after $\tau$, all exit times $\tau^L \in [\tau, \infty)$ are optimal and the high-quality firm never exits. Finally, in order to keep reputation constant at $x^L$, the low-quality firm must exit at constant rate $\psi := -g(a^L, x^L)/x^L(1 - x^L)$ to offset the negative reputational drift due to learning.

C.4 Equilibrium Existence in Theorem 4

The existence proof of Theorem 2 does not apply as stated to Theorem 4, since the time-to-exit $\tau$ is not bounded above, and the theorem statement is stronger, establishing continuity and monotonicity of $x_t$. To achieve this stronger result, we first apply the fixed-point argument to the set of mixed strategies, which does not deliver a self-esteem jump to one; at a private breakthrough reputation is continuous while self-esteem jumps.

Here we sketch a model variant where the firm receives additional private signals about its quality; this bridges the models with unknown and known quality and sheds light on the different findings regarding investment levels around the exit threshold. Specifically, suppose the firm observes private breakthroughs that arrive at rate $\nu$ when quality is high. At a public breakthrough reputation and self-esteem jump to one; at a private breakthrough reputation is continuous while self-esteem jumps.

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C.5 Firm Observes Private Signals about its Quality

Here we sketch a model variant where the firm receives additional private signals about its quality; this bridges the models with unknown and known quality and sheds light on the different findings regarding investment levels around the exit threshold. Specifically, suppose the firm observes private breakthroughs that arrive at rate $\nu$ when quality is high. At a public breakthrough reputation and self-esteem jump to one; at a private breakthrough reputation is continuous while self-esteem jumps.
to one. Absent either breakthrough, self-esteem is governed by \( z = g(a_t, z_t) \) with

\[
g(a_t, z_t) = \lambda (a_t - z_t) - (\mu + \nu) z_t (1 - z_t).
\]

Since the market does not observe the firm’s private breakthroughs, it perceives self-esteem \( z_t \) as random variable with expectation \( x_t \). For \( \nu = 0 \), we recover the baseline model with unknown quality, whereas large \( \nu \) approach the model with known quality.

This model is recursive in the time since the last public breakthrough, \( t \). A recursive strategy for the firm then specifies investment \( a_t \) and exit time \( \tau \) as a function of \( t \) and the history of private breakthroughs. We truncate the firm’s cash flow expansion at either kind of breakthrough to obtain

\[
V(t, z_t^*) = \int_t^{\tau^*} e^{-\int_t^r (r + (\mu + \nu) z_u) du} [x_s - c(a_s^*) - k + \mu z_s^* V(0, 1) + \nu z_s^* V(s, 1)] ds
\]  
(27)

where the additional term \( \nu z_s^* V(s, 1) \), cf (3), captures the firm’s continuation value after a private breakthrough. Analogous to Lemma 6, investment incentives are given by

\[
\Gamma(t) = \int_t^{\tau^*} e^{-\int_t^r (r + \lambda + (\mu + \nu)(1 - z_u^*)) du} \mu [V(0, 1) - V(s, z_s^*)] + \nu (V(s, 1) - V(s, z_s^*)) ds.
\]  
(28)

These disappear at the exit time \( \tau^* \) as in Theorem 1, so the firm shirks close to the exit threshold. Thus, even for large \( \nu \), i.e. close to the known-quality case, investment vanishes at the exit time, in contrast to Theorem 4. However, the known-quality result that the firm fights until the end is robust in the following sense: The integrand in (28) increases in \( \nu \), so fixing \( \tau^* - t \) and considering the limit \( \nu \to \infty \) the integral converges to \( V(t, 1) - V(t, 0) = \Delta(t) \), which is boundedly positive and rises in \( t \), as with known quality.

C.6 Identification

In the text, we discussed that the revenue process \( \{X_t\} \) uniquely identifies \( (\mu, \lambda) \) and investment \( \{a_t\} \). In this appendix we show that the (recursive) exit threshold \( x^e \), revenue \( \{x_t\} \), and investment \( \{a_t\} \) uniquely identify the cost parameters \( (k, c(a)) \). Recall \( \{a_t\} \) is single-peaked in \( t \), hence maximized at some \( \hat{t} \) and decreasing on \( [\hat{t}, \tau] \). Since \( x_t = z_t \), and \( x_t \) is known, we write the firm’s on-path value as \( V(t) \).

First, we fix an arbitrary maximum value, \( V(0) \). The operating cost \( k \) then follow from the exit equation,

\[
x^e - k + \mu x^e V(0) = 0.
\]

For the cost function \( c(a) \), the first order condition (7) and the marginal value of effort (6) imply that

\[
c'(a_t) = \lambda \int_t^\tau e^{-\int_t^r r + \lambda + (\mu + \nu)(1 - x_u) du} \mu [V(0) - V(s)] ds
\]  
(29)

where firm value \( V(s) \) is given by

\[
V(s) = \int_{v=s}^\tau e^{-\int_s^r (r + \mu x_v) du} (x_v - k - c(a_v) + \mu x_v V(0)) dv
\]  
(30)
Taking $V(0)$ as exogenous, and $\{x_t, a_t\}$ as data, $c'(a_t)$ is expressed as a function of $\{c(a_s) : s > t\}$. Using $a_\tau = c(a_\tau) = 0$ as boundary condition, $c(a_t)$ is then identified recursively from $t = \tau$ to $t = \hat{t}$.

Next, we identify $V(0)$. Suppose there are two maximum values, $V_1(0) - V_2(0) = \Delta > 0$ consistent with the data. The exit condition together with $V_1(\tau) = V_2(\tau) = 0$ imply $k_1 > k_2$. Let $t < \tau$ be the latest time with $V_1(t) - V_2(t) = \Delta$. Since $V_1(0) - V_1(s) > V_2(0) - V_2(s)$ for all $s > t$, (29) implies $c_1'(a_t) > c_2'(a_t)$. Since $c_1(a_\tau) = c_2(a_\tau) = 0$, we have $c_1(a_s) > c_2(a_s)$ for all $s > t$. But then (30) together with the higher costs in “scenario 1” imply that $V_1(t) < V_2(t)$ for the “latest time” $t$, and thus $V_1(0) < V_2(0)$, contradicting our original assumption. Intuitively, an increase in the maximum value raises incentives requiring higher costs to justify the observed actions; yet higher costs are inconsistent with a higher value.

This identification approach is very sensitive to the details of the model. In practice one might rather adopt the more robust, semi-parametric approach of Bajari, Benkard, and Levin (2007). Specifically, given $\{x_t, a_t\}$, one would calculate value functions (1) for any cost parameters $(k, c(a))$, and then choose those parameter values that minimize the gains from deviations measured by, say, violations of the first-order condition $c'(a_t) = \lambda \Gamma(t)$.
References


