- Title: Risk-Taking and Moral Hazard under Limited Liability: Quantifying the Role of Motivated Beliefs
- Abstract: This paper investigates whether limited liability and moral hazard affect risk-taking through motivated beliefs. On the one hand, limited liability can encourage investors to take on excessive risks. On the other, excessive risk-taking makes it hard for investors to maintain a positive self-image in the presence of moral hazard. Using a novel experimental design, we show that subjects form motivated beliefs to self-justify their excessive risk-taking. The results show that when failure can harm others, subjects invest more and are more optimistic about the success of the same investment opportunity. Additionally, we quantify the effects of motivated beliefs and show that they explain more than one-third of the increase in investment under limited liability. Finally, through a treatment with limited liability but no moral hazard, we show that motivated beliefs can lead investors to the paradoxical outcome of taking larger risks when their investment can harm a third party than when they cannot. These results emphasize the importance of motivated beliefs in financial markets and suggest that regulators should address not only bad incentives but also ''bad beliefs.''