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Introduction

Many large corporations delegate investment decision-making authority to their divisions.[1] Not headquarters but rather divisional managers are frequently responsible even for major investment decisions. Delegation has important advantages including the fact that divisional managers are usually better informed about the product market they are responsible for.[2] Hence in principle, they should be able to make better decisions from a company's perspective, i.e., they should be able to maximize the value of the company by making the right decision.

However, divisional managers are usually not machines acting automatically in the best interest of the company's owners. They rather are human beings who are more likely to maximize their own utility instead of objectives imposed by an organization. Therefore, delegating decision-making to better informed managers means that these managers have room to pursue their own objectives, possibly different to those of the company. In this case, the company has to use instruments to align the manager's objectives with those of the company's owners. In case of full delegation of investment decision-making authority, the manager should have an incentive to make exactly the same decision, headquarters would make had it the same information as the better informed manager. If headquarters wants to use the manager's information for making a decision on its own, it has to design an instrument that ensures truthful reporting of the manager's information to headquarters. In this case, only information gathering is delegated but investment decision-making is centralized.

[1] A survey by Reece & Cool (1982) among large U.S. firms indicates that almost three quarter of the responding firms delegate decision-making authority to investment centers.

[2] See, Milgrom & Roberts (1992), pp. 544-545.

There is a whole variety of instruments that ensures either truthful reporting of information, which is available decentrally or helps to align the interests of divisional managers and their companies. Each of these instruments makes some assumptions regarding its effects on human motivation and behavior. A basic distinction on a person's motivation within companies is whether it is intrinsic or extrinsic.[3] For intrinsic motivated managers, external rewards only play a minor role. It is less important to give these persons incentives in order to ensure that they choose the right action choices. For extrinsic motivated managers, the prospect of external rewards such as performance-based compensation is a source of motivation. They have to be given incentives to align their interests with those of the company. In line with much of the economic literature on incentives within organizations, in this work I restrict myself on the case when managers are extrinsic motivated and pursue different objectives than the company. Of course, I do not question the importance of analyzing reasons and effects of intrinsic motivation. However, in my view the significance of extrinsic motivation justifies a separated analysis.[4]

The literature has extensively analyzed the case of delegated investment decision-making when a divisional manager is better informed about the profitability of investment projects than headquarters. Similarly to this work, the focus at least of the economic analyses has been on incentive instruments, which address the extrinsic motivation of managers. However, most of this literature has taken a very simple view of corporate investment decisions. It usually considers investment projects as a single yes-or-no-decision with a certain or uncertain outcome.[5] Once the investment decision has been made, there is no room for additional subsequent decisions. Clearly, this view is a considerable simplification of reality, where many projects require subsequent decisions. In research and development investments, for example, after the initial investment decision has been made, it is necessary to decide whether the project should be continued or not. A factory that has been built for different product lines requires subsequent decisions on the kind of product line to be produced. Within the investment valuation literature, this prop-

[3] See Neuberger (1980), p. 1361.

[4] For an experimental study analyzing the importance of intrinsic and extrinsic motivation in a capital budgeting setting see Butler, et al. (2002). The interaction between intrinsic and extrinsic motivation is discussed by Kreps (1997) and formally analyzed by Benabou & Tirole (2002).

[5] Frequently, the literature assumes a continuum of investment levels, where the single yes-or-no-decision is substituted by a decision on the exact level of investment expenditures out of a continuum of possible choices.