Incentives, Project Choice and Dynamic Multitasking*

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Abstract

I study the optimal choice of investment projects in a continuous time moral hazard model with multitasking. While in the first best, projects are invariably chosen by the net present value (NPV) criterion, moral hazard introduces a cutoff for project selection which depends on both a project's NPV as well as its signal to noise ratio (SN). The cutoff shifts dynamically depending on the past history of shocks, the current firm size and the agent's continuation value. When the ratio of continuation value to firm size is large, investment projects are chosen more efficiently, and project choice depends more on the NPV and less on the signal to noise ratio.

The optimal contract can be implemented with an equity stake, bonus payments, as well as a personal account. Interestingly, when the contract features equity only, the project selection rule resembles a hurdle rate criterion.

1 Introduction

The standard paradigm for firm investment posits a continuous investment decision. Firms choose investment as a means to regulate their capital stock, which, except for adjustment costs, is perfectly scalable. While for certain firms, this framework may be reasonable, for

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