

Letting Go: Managerial Incentives and the Reallocation of Capital*

Andrea L. Eisfeldt Adriano A. Rampini
Northwestern University Northwestern University

February 2004

Abstract

This paper studies the provision of incentives to reallocate capital when managers are reluctant to relinquish control and have private information about the productivity of assets under their control. We show that when managers get private benefits from running projects substantial bonuses are required to induce managers to declare that capital under their control is less productive and should be reallocated. When aggregate productivity and hence the number of projects is low and fewer managers are required to run projects such bonuses would leave managers with unnecessary rents. This means that it is more costly to induce reallocation and thus less capital is reallocated. From the investor's perspective, capital is more illiquid in bad times since too much of the gains from capital reallocation would accrue to managers.

JEL Classification: E22; E32; E44; G34.

*Address: Department of Finance, Kellogg School of Management, Northwestern University, 2001 Sheridan Road, Evanston, IL, 60208. Eisfeldt: Phone: (847) 491-7843. Email: a-eisfeldt@northwestern.edu. Rampini: Phone: (847) 467-1841. Email: rampini@northwestern.edu.