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“Taken for a ride”

The pay of chief executives can seem ridiculous. Often, it is. In corporate America's crisis of confidence, bosses' pay looms large. Public opinion probably sees this as the worst of the scandals in question. Many economists, inclined to give markets a chance, take a different view. They reckon the market for scarce talent is working pretty well. They are most likely wrong.

In thinking about executive pay, economists reach first for optimal contracting theory. According to this view, corporate boards design executive pay to mitigate the “principal-agent problem” that bedevils the relationship between shareholders and managers. Boards aim to align the interests of managers with the interests of owners by building various incentives into managers' contracts.

Seen this way, the technology for aligning incentives has been improving lately—witness the growing, and in some cases dominate, role of stock options in top executives' pay. These schemes sometimes hand out vast sums. According to the optimal contracting model, this is good for owners, because it rewards managers for doing things that increase the value of the company. Once in a while, advocates concede, such plans may be abused. Crooked bosses may manipulate stock-option plans to subvert the principle; no scheme is proof against outright dishonesty. By and large, though, the growth of stock-option plans is not to be deplored, but should be welcomed as a step forward in corporate governance.

Does the optimal-contracting view make sense? A recent paper** by three scholars from Harvard Law School and the University of California, Berkeley, says it does not. They advocate another approach, which they call the managerial-power view. They plausibly argue that it makes better sense theoretically and empirically. And they draw from this approach the

* “Managerial Power and Rent Extraction in the Design of Executive Compensation” by Lucian Bebchuk, Jesse Fried and David Walker. Forthcoming in the University of Chicago Law Review.

interesting implication that many (not a few) top executives are skimming mighty rents—incomes in excess of what market efficiency and maximum shareholder value would dictate—from the people who employ them.

The key assumption of the optimal-contracting view is that managers and shareholders, in effect, negotiate at arm's length over pay. Basic training in economics is needed to blind one to the absurdity of this assumption. Top managers direct or at the very least influence the board members who set their pay: that means they will succeed in collecting some rent. The only question is how much.

One of the constraints on this activity will be how angry shareholders and the public at large get about bosses' pay: the paper talks of norms of acceptable behavior and “the outrage constraint”. The importance of public relations puts a premium on compensation schemes that disguise managers' terms. In theory, stock options could align managers' incentives with shareholders' interests. In practice, very often, they are used mainly to conceal the diligent collection of rent—quite possibly with perverse, not merely neutral, implications for incentives.

Consider the following features of stock-option plans as typically implemented by big American companies:

- Rewarding mediocrity. Optimal contracting would lead you to expect a stock-option design that filtered out general rises in stock prices, so that bonuses were paid only for better-than-average performance against some relevant benchmark. Such features, the paper shows, are rare.

- At-the-money options. Optimal contracting would suggest great variety, according to circumstances, in the exercise price of the options granted. (By varying the exercise price, the power of the incentive can be fine-tuned.) There is no such variety. Options are almost universally granted with an exercise price equal to the prevailing market price.

- Resetting. The incentive effects of options are undone if executives expect prices to be reset when the company's shares fall. This is a widespread practice.

- Unwinding. A requirement of optimal stock options is that managers should be unable to hedge the risks the options create. Hedging is almost never prohibited. Also, almost invariably, managers are allowed to cash out their options as soon as they are vested. (Incentives aside, managers have inside information: this allows profits to be made at the expense of public shareholders.) Logically, boards should restrict and control the sale of bosses' shares. They rarely do.

- Reloading. This is the practice of letting executives exercise options when the share price is high, at the same time granting new options with the old expiration date. This lets managers profit from volatility in share prices even if the overall trend in the company's value is flat. It should be rare. It is common.

This is to say nothing of “gratuitous payments” (bonuses, often related to acquisitions, for which the firm was under no contractual requirement, and which served no incentive-related purpose). None of these aspects of executive pay in practice, the authors contend, can be easily explained by optimal contracting. They can be easily explained by managerial power—that is, by rent extraction.

How to remedy this is not an easy question. Aggressive regulation could do more harm than good. But note that outrage, as in the outrage constraint, has its uses. Economists who defend bosses' outlandish pay may be serving the cause of market forces badly. Tighten that constraint. More deploring and less defending would help curb those rents.