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The Outrage Constraint

By PAUL KRUGMAN

The high pay of America's C.E.O.'s reflects intense competition among companies for the best managerial talent. Stock options and other typical forms of executive compensation are designed to provide incentives for performance. These incentives align the personal interests of managers with those of shareholders.

Nothing in the preceding paragraph is true. That's the message of an extraordinary research paper circulated by the National Bureau of Economic Research, an economics think tank. The paper is must reading for anyone trying to understand what's really going on in our economy.

I first read this paper, "Executive compensation in America: Optimal contracting or extraction of rents?" by Lucian Bebchuk, Jesse Fried and David Walker (of Harvard, Berkeley and Boston University respectively), last December. It was largely due to their analysis that I concluded, early in the game, that Enron would be only the first of many scandals.

What they show is that the official theory of the corporation, in which the C.E.O. serves at the pleasure of a board that represents shareholder interests, is thoroughly misleading. In practice, modern C.E.O.'s set their own compensation, limited only by the "outrage constraint" — outrage not on the part of the board, whose members depend on the C.E.O.'s good will for many of their perks, but on the part of outside groups that can make trouble. And the true purpose of many features of executive pay packages is not to provide incentives but to provide "camouflage" — to let C.E.O.'s reward themselves lavishly while minimizing the associated outrage.

The most obvious case in point is stock options. There is a good argument for linking an executive's pay to his company's stock price, but a true incentive scheme would have features that one almost never sees in practice. For example, an executive's pay should depend on his company's stock price compared with a benchmark index composed of other, similar companies, so that what he gets reflects the job he is doing, not general market conditions.

In fact, however, a C.E.O. almost always receives stock options at the current market price — end of story. If the stock price goes up, he cashes in. If it goes down, he receives new options at the lower price. There are, to be fair, quirks in the tax law that encourage this practice. But the main reason executives are paid this way is that it gives them an almost sure thing — unless the stock falls steadily, sooner or later an executive who keeps getting options at the current price makes a lot of money — yet does so in a way that camouflages the sweetness of the deal. The options grant often isn't even counted as a corporate expense, and the payoff, when it comes, can always be represented as a reward for achievement.

Thanks to the growing skill of companies at camouflage, and also to a steady erosion of old inhibitions against apparent excess, the average pay of C.E.O.'s at major companies has skyrocketed. It was "only" 40 times that of an average worker a generation ago; it's 500 times as much today. That's a lot of money, but the direct expense is not the main problem. Instead, it's the fact that the tricks used to camouflage exorbitant pay give executives an enormous incentive to get the stock price up in time to cash in their options.

We're only beginning to see the extent to which that incentive distorts corporate behavior. We now know that some companies engaged in grandiose programs of acquisition and expansion that ended in grief — but only after top executives had profited immensely. We also know that companies eager to meet or surpass analysts' expectations engaged in creative accounting on a grand scale: in each of the last few years of the bubble most big companies reported double-digit profit growth, yet national statistics show that true corporate profits were hardly growing at all.

I'm not claiming that C.E.O.'s are conscious villains, twirling their mustaches and chortling over their evil doings. People are very good at rationalizing their actions — even Jeff Skilling reportedly regards himself as a victim — and the great majority of C.E.O.'s surely stayed within the letter of the law.

But the fact is that we have a corporate system that gives huge incentives for bad behavior. And I would be very surprised if Wednesday's plea by Enron's Michael Kopper is the beginning of the end; at best, it's the end of the beginning.