Curbs on Covetousness: Envy can make Capitalism more Efficient and Help to Restrain Executive Pay


By CHRIS GILES

In one of his less articulate moments, John Major, the former prime minister, said: "Society needs to condemn a little more and understand a little less." He was talking about youth crime. But new research suggests his sentiments would be better directed at the pay packages of chief executives.

The politics of envy should be encouraged. The efficiency of capitalism and the wealth of shareholders depend on it.

Consider Enron. Had there been widespread outrage when Kenneth Lay and other senior executives netted considerably more than Dollars 100m (Pounds 70m) from sales of Enron stock, the damaging publicity might have helped to avoid some of their other excesses. Had Mr Lay been barred from exercising options while he still worked for Enron, his urge to drive up the share price artificially would have been diminished. Enron employees, other shareholders and society at large would have benefited.

Of course, drawing wider conclusions from one example of egregious managerial excess is a cheap shot. It is also unnecessary. There is abundant evidence that US chief executives have been profiting at shareholders' expense.

Economic theory has long understood that there is a serious principal/agent problem between owners and managers of companies. Shareholders (principals) need to get corporate executives (agents) to act in their interests, namely to maximise shareholder value. But managers have other ambitions, from enriching themselves to building corporate empires.

This problem can never be solved but economists accept that it can be minimised by giving CEOs pay deals that depend to a large extent on shareholder value.

In this optimal contracting view of the world, managers' incentives are in effect aligned with those of shareholders. That mechanism was behind the explosion of stock options in the 1990s.

But there is another explanation, outlined by economics and law academics from Harvard and Berkeley*. Prof Lucian Bebchuck, Prof Jesse Fried and David Walker argue that the pay and perks packages of CEOs better resemble "rent extraction" than optimal contracting. Rather than CEOs' compensation packages mitigating the principal/agent problem between shareholders and managers, they are the manifestation of it.

CEO contracts bear little relation to the optimal contracts assumed in economic theory.

First, the company boards that set remuneration in the US are rarely as independent of the CEO as would be ideal. CEOs have influence in choosing independent non-executive directors and about 25 per cent of compensation committee members were once CEOs themselves.
Second, market forces are weak in restraining excess. The market for corporate control is unlikely to be effective. If a company is taken over, the new management is just as likely to extract rents as the old. And outside perfectly competitive product markets, consumers cannot constrain pay. As long as the company is profitable, managers have an incentive to appropriate as much of that profit as possible.

Third, the law is complicated and slow so shareholders have not gone to court to throw out particularly generous packages.

Over the 1990s, CEO compensation packages supported rent extraction. Share options can help to align managerial and shareholder interests - but more were given than necessary and the type generally paid are relatively ineffective incentives. Share options are rarely indexed to a company's relative performance against its peers, enabling lucky rather than good executives to prosper.

Most options are priced at-the-money, with an exercise price equal to the company's stock price. This gives managers the greatest potential gain at the lowest cost - hardly an optimal contract for shareholders. And executives are generally allowed to unwind their options, or hedge against them while still employed. That can eliminate any alignment of their incentives with those of shareholders.

Of course, there are constraints on CEOs. Most cannot fleece shareholders willy-nilly. The most important constraint, according to Prof Bebchuck and his colleagues, is an "outrage constraint". "Directors would be reluctant to approve, and executives would be hesitant to seek, compensation arrangements that might be viewed by observers as outrageous," they argue. Non-executive directors would shy away from approving pay deals that risked sullying their reputations. CEOs do not want their pay to be scrutinised publicly by politicians or the media.

The outrage constraint can be minimised by CEOs. If their pay is so complicated that it is difficult to scrutinise, they can extract more rent. Unsurprisingly, CEOs have increased the camouflaged elements of their pay: between 1992 and 1998, the salary of the average chief executive rose by 29 per cent, the average bonus increased by 99 per cent and the average value of options granted rose by 335 per cent. Prices rose by just 16 per cent.

Outrage clearly is a constraint, otherwise shareholders would, as with Enron, get nothing. But it seems not to have been vocal enough, particularly in the US, where executive compensation dwarfs that in other countries.

So the next time you hear of the huge rewards made by a corporate CEO and get a pang of jealousy, vent those feelings. You will just be doing your bit for efficient capitalism.

* Executive compensation in America: optimal contracting or extraction of rents? John M. Olin Centre for Law, Economics and Business discussion paper No. 338. www.law.harvard.edu/programs/olin_center/chris.giles@ft.com

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