Economic Scene: Where Are the Economists?

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By JEFF MADRICK

WHEN you think about the economic issues facing the next president, you have to wonder why either candidate wants the job. There are the outsize budget deficits, high levels of private debt, a soaring trade deficit, growing numbers of Americans without health insurance, a possible bust in the housing bubble and an expansion that is not creating enough jobs and is probably already tapering to a crawl.

But at least these issues have come up in the campaign. One issue that has not is the corporate scandals that rocked the nation two years ago. Now Eliot Spitzer, New York's attorney general, has uncovered another dark hole of apparent corporate wrongdoing among the nation's largest, most respected insurance companies.

It is fair to ask where the federal government has been. But it is also fair to ask where the economists are.

"The economists are leaving this mostly to the law schools," said the Yale economist Robert J. Shiller, author of "Irrational Exuberance," the best seller about the overvalued stock market. "They are not comfortable with issues concerning human behavior."

To be a little more precise, there is a lot of economic research in the field, but it often reduces behavior to a set of predictable possibilities. "They see the organization as merely a nexus of individual contracts," complains Rakesh Khurana, an assistant professor of organizational behavior at the Harvard Business School and author of "Searching for a Corporate Savior" (Princeton University Press, 2002). "This is a highly unrealistic description and has no support in any social science other than economics."

Of course, knowing economists, that might make them proud. But the result is that many economists lean against financial regulation in general and have been in favor of only modest reforms in the wake of the scandals.

The general argument they make is that free markets check corrupt behavior more than is realized, the courts can handle other disputes, and government regulations often serve business interests anyway.

To David A. Skeel, a University of Pennsylvania law professor, however, reforms are badly needed to correct conflicts of interest and abuses in executive compensation. And the opportunity to adopt them does not come around often.

Interest in any serious reform almost fizzled, in fact, after the Enron scandal in late 2001, and was revived only with revelations that WorldCom misstated profits by roughly $11 billion.
"After WorldCom, President Bush made a speech saying it was just a few bad apples," Mr. Skeel says. "But that didn't go over well in the financial community any longer. They wanted firmer action. Finally, he supported the Sarbanes-Oxley bill."

Mr. Skeel and others say Sarbanes-Oxley, the principal reform measure to come out of the scandals, is inadequate. It largely calls for new disclosure requirements and more independent auditors. In a new book, "Icarus in the Boardroom" (Oxford University Press), Mr. Skeel proposes a number of new reforms, including more stringent demands for independent auditing. He would require auditors to be assigned by the stock exchanges themselves.

The true measure of the lame regulatory environment, however, has been the lack of action, either by the accounting standards organization or the government, to restrain the stock options so generously given to top executives.

Academic research strongly supported aligning executives' incentives with rising stock prices. But when options gave them the right to buy shares in the future at a given price, executive income soared.

In 1991, the average chief executive of a large company earned 140 times the pay of an average worker. By 2003, it was 500 times.

Lucian A. Bebchuk, professor of law, economics and finance at Harvard Law School, and Yaniv Grinstein of Cornell Business School find that a proper calculation of the total compensation of the top five executives of all companies, including salaries, stock options and pensions, came to a stunning $260 billion over the last 10 years.

This might be justifiable if there were ample evidence it was based on market performance or corporate earnings. But Mr. Bebchuk and Mr. Grinstein find that since the early 1990's pay has risen about twice as fast as the market value of stocks and much faster than corporate income. Total compensation was 5.7 percent of total corporate income in the early 1990's; it is now under 10 percent.

Mr. Bebchuk concludes that, contrary to arguments made by many economists, compensation agreements between boards and high-level executives are not done at arm's length; managers have a great deal of influence over what they get paid. Moreover, the options so widely advocated by these economists can often induce misbehavior as executives misstate earnings and liabilities, and take on dubious projects, to pump up stock prices in the short run.

In a new book, "Pay Without Performance" (Harvard University Press), Mr. Bebchuk, along with another law professor, Jesse M. Fried of the University of California, Berkeley, propose reforms to link compensation and performance more closely. Like many other observers, they want options listed on financial statements to make compensation transparent.

But they also say directors' compensation should be tied to stock prices. Most important, they argue, making directors more independent, as the New York Stock Exchange now requires, is not enough. They want shareholders to have far more power to vote for new directors, and
thereby make directors more accountable. Now, access to the corporate ballot is limited.

In the meantime, it is Mr. Spitzer, not Washington, who keeps up the most pressure on corporations. Mr. Spitzer got investment banks to agree to separate stock analysis from corporate underwriting. Analysts were producing misleading research to win investment banking business for their firms. And while the Securities and Exchange Commission is issuing some new requirements, Frank Partnoy, a law professor at the University of San Diego, says corporate whistle-blowers now tend to go to New York, not Washington.

The next president may be able to generate the enthusiasm needed for serious reform. But given the near silence during the campaign, only another major round of scandals may accomplish that.

At least there are cracks in the economists' armor. Some, usually at the law and business schools, are making economically sound cases for new rules and regulations. Whoever is president in the next four years can use some fresh advice.

Jeff Madrick is the editor of Challenge Magazine, and he teaches at Cooper Union and New School University. His most recent book is "Why Economies Grow" (Basic Books/Century Foundation). E-mail:challenge@mesharpe.com.