How an economic theory changed the way CEOs get paid

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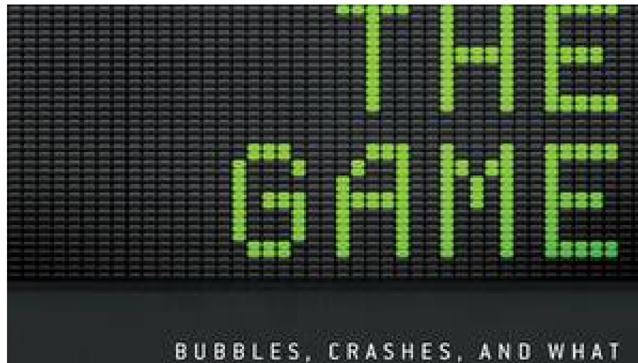

The past 70 years have seen three massive, value-destroying market crashes. After each, regulators have attempted to punish wrongdoers and implement fixes to prevent future meltdowns. It hasn't helped, because regulators have focused on symptoms instead of root causes. The only way we can avoid increasingly frequent stock market meltdowns-and all the pain, suffering and economic dislocation they cause-is to explore the theories that underpin American capitalism. One theory in particular deserves our close attention, due its pervasiveness and power - shareholder value theory.

In 1976, finance professor Michael Jensen and Dean William Meckling of the Simon School of Business at the University of Rochester published a seemingly innocuous paper in the Journal of Financial Economics entitled "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure." It would go on to be the single most frequently cited article in business academia and forms the prevailing theory of the role of the firm and proper compensation in our society today.

The article first defined the principal-agent problem and created agency theory. In the authors' construct, shareholders are the principals of the firm-i.e., they own it and benefit from its prosperity. Executives are agents who are hired by the principals to work on their behalf. The principal-agent problem occurs because the agents have an inherent incentive to optimize activities and resources for themselves rather than for their principals. For example, an executive might declare her own time to be so valuable that she requires a private jet to ferry her around. While this might be convenient for the executive, and may even increase her productivity level, it may well hurt the owners of the company, reducing earnings by more than the increase in productivity. Such a choice puts an agent's interests ahead of those of the principals and creates an agency cost.

Jensen and Meckling argued that when executives squander firm resources to feather their own nests, the result is both bad for shareholders and wasteful for the economy. Instead, the theory goes, the singular goal of a company should be to maximize the return to shareholders. To achieve that goal, the company must give executives a compelling reason to place shareholder value maximization ahead of their own nest-feathering. While it is not possible to entirely eliminate the self-interest of executives, the authors posited that we could better align that self-interest with the interests of shareholders; we could eliminate agency costs by giving agents meaningful amounts of stock-based compensation, actually making them shareholders as well as executives. Executives would then be very interested in increasing shareholder value, because when it increased, so would their own compensation.

Like all good theories, agency theory had limitations and unexpected side effects, a fact its disciples have chosen to ignore (though Jensen himself has acknowledged them). In particular, the theory had the unfortunate effect of tightly tying together two markets: the real market and the expectations market.

The real market is the world in which factories are built, products are designed and produced, real products and services are bought and sold, revenues are earned, expenses are paid and real dollars of profit show up on the bottom line. That is the world that executives control-at least to some extent.

The expectations market is the world in which shares in companies are traded between investors-in other words, the stock market. In this market, investors assess the real market activities of a company today and, on the basis of that assessment, form expectations as to how the company is likely to perform in the future. The consensus view of all investors and potential investors as to expectations of future performance shapes the stock price of the company.

Historically, professional managers played entirely within a single market: they were in charge of performance in the real market and were paid for performance in that real market. That is, they were in charge of earning real

profits for their company and they were typically paid a base salary and bonus for meeting real market performance targets.

Compensation rooted in the expectations market used to be rare. In 1970, for example, stock-based incentives accounted for less than 1 percent of CEO remuneration. But that all changed after the advent of agency theory. Implicitly, Jensen and Meckling had argued that the way to spur executives to best perform their duties in the real market was to make their pay significantly dependent on the performance of the company in the expectations market. This was a critical shift. After 1976, executive compensation became increasingly stock based, so that when executives produced a stock price increase in the expectations market, their compensation rose dramatically. In 2009, for instance, the highest-paid CEO in American was Larry Ellison of Oracle, and estimates suggest that 97 percent of his paycheck came from realized gains on options. Ray Irani, CEO of Occidental Petroleum, earned $31 million in 2009, including $1.17 million in base salary, a bonus of $1.2 million and restricted stock awards of just under $25 million. It has become an accepted premise of good governance that, in order to properly align their incentives with those of the shareholders, executives and board members must receive a substantial portion of their pay in the form of stock-based compensation. The market crashes of 2000-2002 and 2008-2009 did nothing to diminish this premise; in fact, they strengthened it.

Few people conceive of the world of business in terms of real and expectations markets. Yet, there is another world in which the distinction between a real market and an expectations market is much more profoundly understood-the National Football League (NFL). While it isn't a perfect metaphor for business, it is a highly instructive one. It is one we will pursue tomorrow.