

THE MEN WHO DESIGNED YOUR BONUS WIN A NOBEL

Honours Two giants of economic thought have been recognised for contributions to contract theory, writes former student, UNSW and Harvard economics professor Richard Holden.

Suppose you are a director of a public company: what mixture of salary, bonuses and stock options should you give to your CEO, or other managers? Should their pay be indexed to that of their competitors, or the stockmarket in general? Or suppose you are that CEO. Should you own your suppliers, or write a contract with them. What about your distributors? How long should that contract be? What terms should it contain?

The economists who laid the intellectual foundation for addressing these questions were recognised on Monday, when the Nobel Prize in Economic Science was awarded to Oliver Hart of Harvard University and Bengt Holmstrom of MIT – for their contributions to contract theory. (Disclosure: Hart was chair of my PhD thesis committee at Harvard, Holmstrom a colleague at MIT.)

The classic contracting problem that Holmstrom considered is known as the "Principal-Agent problem". A principal (e.g. a board of directors) hires an agent (e.g. a CEO) to take some actions on her behalf (e.g. running the company). The principal can't observe the action the agent takes, but can observe some noisy measure of them (e.g. the stock price or profits).

As Adam Smith long ago observed, this separation of ownership and control can cause problems: "being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigil-

ance with which the partners in a private company frequently watch over their own."

This raises the possibility that an incentive contract between the owners and the managers can ameliorate these negative effects to some degree. But how should it be structured? With salary, bonuses, stock options, the threat of dismissal, and other instruments at their disposal, the owners could, in principle, write a very complex contract.

In his first major contribution, Holmstrom showed what set of performance measures should be part of the contract. His so-called "informativeness principle" basically says any performance measure that provides additional information about the actions the agent took should be part of the contract.

A striking implication of this is the managers should not be rewarded for luck. An oil company CEO who cannot control the oil price should not get a windfall gain (or loss) from movements in the oil price. The optimal contract should filter that out. To use a topical example, bank CEOs should not benefit from a general rise in the banking sector (say, because of interest rates) – their stock prices should be indexed to the stock prices of their competitors.

In practice these things are rare, which raises the question of whether contracts – and hence corporate governance – is actually in the interests of shareholders. This has had enormous practical significance, as well as stimulating a massive body of research.

Hart's contribution begins with the observation that contracts are typically incomplete – they cannot, and do not, specify all



Nobel prize winners Bengt Holmstrom (above) of the Massachusetts Institute of Technology and (right) Oliver Hart, the Andrew E. Furer Professor of Economics at Harvard. PHOTOS: AP



themselves. This leads to optimal investment – and hence more economic surplus. Hart's theory – which has become known as "property rights theory" – implies that the party whose relationship-specific investment is more important should own the other.

This has powerful implications for the boundary of the firm: who should own whom, and what businesses to be in. It also has profound implications for government. Should governments own schools, or just pay for them? Should they own electricity distribution, or prisons? I wrote about this on these pages before the last NSW election.

Beyond this, it has been applied to understanding the design of political and legal institutions, such as national constitutions. Hart and Holmstrom have helped us understand how contracts and asset ownership shape economic interactions and highlighted the importance of the legal system in mediating economic activity.

The Nobel committee has shown impeccable taste in honouring two giants of the discipline who have inspired a generation of scholars. Bravo.

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possible future contingencies. This leads to the possibility that if some contingency not covered by the contract arises, the parties will need to renegotiate the terms. They will do so to maximise the value of their relationship (as 1991 Laureate Ronald Coase emphasised). But such a bargain will inevitably split the gains from renegotiation between the two parties in some way.

And anticipating this – not receiving all the gains from renegotiation – each party will underinvest in the relationship. For instance, they might not tailor their products, plant or equipment as they would if they received all the benefits from doing so.

What to do? Well, it might make sense for one party to buy the other party. Then they just negotiate with, and split the gains, with

Killing careers with kindness: the risks of revealing

Men's health



Jill Margo

David Westgate was having lunch in Sydney with his old boss recently when he casually revealed he'd been living with bipolar his entire adult life.

"Isn't it odd," his boss replied. "I never knew for a minute that you suffered from it, and there I was suffering from acute anxiety all my life and you didn't have a clue about that either."

Westgate, 59, who had a successful career in multinational advertising agencies and now runs his own agency, was floored.

"How could it be? We worked side by side, often through 14-hour days, for eight years and had no idea what each other was going through."

For most of his career, Westgate remained undiagnosed. As a young man he'd been encouraged to see a psychiatrist, but it was such an ordeal he decided never to repeat it. "I thought, I can handle this stuff myself," which is exactly what I did for

the next 20 years."

He went through deep depressions and extreme highs but told himself that everyone probably had them too, and resolved simply to push through. Over the years, it wasn't that simple. When he felt teary at work he'd take refuge in the men's room or if depression had kept him up all night he'd leave the office, park in a quiet spot, set his phone alarm and sleep for two hours before returning.

"I suffered in secrecy, which is the modus operandi for the majority of career people who live with mental illness. Privacy is paramount because of the fear that with disclosure one's career – and the whole life structure built upon it – will collapse."

Although those with mental illness might have full faith in the benevolence of their managers and colleagues, there is every chance that with disclosure their career could be killed with kindness.

A caring manager might leave them off a project thinking it was too challenging. If this happened once too often, questions might arise about if they were still needed.

"My career was my asylum, so for me it was best to keep my mouth shut," he says.

My career was my asylum.

David Westgate



"There are hundreds of thousands of people, hiding like I did, who form part of a sad iceberg drifting slowly through corporate Australia."

For all the years that Westgate's mood disorder didn't have a label, he knew he was living with deep instability. A recent review of 27 studies involving 9000 people with bipolar disorder showed they waited an

average of six years to disclose their symptoms. Westgate waited much longer, and is now interested in the mechanics, benefits and consequences of disclosure in a corporate setting.

"Corporations make a big effort to address mental illness and should be congratulated for it, but they are in a catch-22. They want to help because it's the right thing to do and it's a smart thing to do for productivity. It seems so rational, but they are dealing with a problem that can be anything but rational.

"They train managers to identify people with mental illness and offer help but, for numerous reasons, many don't want to be identified. It's estimated 65 per cent of people don't reveal a mental illness.

"When I was diagnosed and began coming out to colleagues, the standard reaction was 'I would never have picked it'. "So it doesn't matter how much you train staff about what to look for, if mentally ill people decide not to be open about it, in most cases they won't be identified."

He believes corporations are ineffective because their approach is misguided. "Their programs are top down, implemented by

