Entrepreneurship, Compensation and the Corporation

By Henry G. Manne

Much of the economics literature on the compensation of various personnel involved with the large, publicly-held business corporations has failed to come firmly to grips with three important economic realities. The first is that there is no single model of corporate organization which will turn up valid answers for all occasions. The business corporation is a many-splendored thing, ranging from the elemental, one-person corporation to the giant behemoth with millions of shareholders no one of whom has anything like a controlling influence on corporate affairs. In between these two lie every conceivable combination and permutation of ownership distribution, contractual (charters and by-laws included) provisions relating to managerial authority and to compensation, product market influences, organizational culture, norms and applicable laws.

The second reality is that there are numerous economic functions involved in every corporation, though these intellectually distinguishable functions are rarely isolated for cogent analysis. Shortage of a rich vocabulary may be part of the problem, but chances are that analytical lethargy plays a larger role. For example we frequently use the word "entrepreneurship" to describe the organizational (and sometimes purely managerial) task of founding a business, as though that were the sole role of the entrepreneur. Manifestly it is important, but just as clearly entrepreneurial innovation does not cease with the formation of a business firm. Innovation and discovery may and do regularly occur in all phases of business enterprise, from production to finance to human resources to marketing and so on, even though these areas of potential innovation are rarely seen as the quintessential venues of the entrepreneurial function in the large corporation. And in truth technological innovations within the large corporation may on occasion be nothing more than the product of the exercise of a managerial function.

The risk-taking function too is often confounded with the entrepreneurship function, even though each of these functions may exist exclusively, with no trace of the other, since obviously economic risk can be transferred by contract to someone who bears no entrepreneurial responsibility. Successful innovation comes in many forms and in many areas of business, far too many, as we shall discuss below, to allow us to plan meaningfully for how to compensate for specific examples as they appear.

The third source of fuzzy analysis of corporate affairs arises with the failure to be clear about what is meant by "compensation". In common parlance we generally mean this term to cover salaries, bonuses, stock options and various perks of office transferred to an employee in exchange for the performance of a specified amount and quality of effort. And here things begin to get complicated, for surely compensation is, in an economic, non-legal sense of the term, every good or benefit (including opportunities) offered up on one side of a contract. That may include, for examples, working conditions, access to exogenously valuable knowledge, interpersonal relationships, potential for promotion, reputational gains or lax monitoring, none of which ever shows up explicitly in contracts, but each of which may be a very important part of the compensation picture.

When we put these three complexities into one mix, we begin to see the difficulty of ever making sense of the entrepreneurial compensation quagmire. We rarely even know when the entrepreneurial function is being rewarded in corporate development (apart, perhaps, from the case of stock granted to a promoter on the formation of a firm), as there are too many confounding circumstances to allow discrete measurement. A corporate founder may also be the inventor of a product which is to be marketed by a company that he or she forms by assembling the founder's personal capital and labor and that of other contributors. He or she may own shares and, at the same time, draw a salary and other compensation, compete in the market for corporate managers, retire early, trade profitably in the stock market and enjoy the regard of his or her community. Which of these is the entrepreneurial compensation, which is the return to capital, which is the managerial compensation, and which is just plain luck? No amount of regressing can give us a clear answer to this question.

To complicate matters further, we do not even have general agreement on exactly how to define the entrepreneurial function. The Austrian-school economists, particularly Israel

Kirzner[1], have offered the most integrated, robust and consistent theory of the entrepreneur, though that approach is still handled at arm's length by most mainstream economists. The Austrian theory has the entrepreneur as the "discoverer" of new combinations of resources, new ways of doing things, a new product or an innovation in marketing or a new organizational form or, more succinctly, whatever shakes up the status quo. But this approach, with its focus on a kind of Knightian uncertainty[2] about what an entrepreneur will produce, confounds the compensation issue even more, since the output of the entrepreneurial function can never be anticipated or known in advance. If it were predictable, it would no longer be entrepreneurial, and, as we have seen, even when its presence is sensed after the fact, it is generally too difficult to separate from other functions to allow precise reward. Still, we know that an entrepreneurial function exists because there can be no real economic progress without this function. As Schumpeter pointed out long ago[3], entrepreneurship is the very factor which avoids a perfectly static equilibrium, a circular system with no progress.

So there's a howdy-do, an economic function necessary to the very idea of progress but with no obvious way of specifically identifying it or compensating for it. But the operative term there is "obvious," since indeed we know that in one way or another the function is being provided and, if it is being provided, then it is most likely being compensated for. Knight's hunch that entrepreneurship in aggregate was provided freely, i.e. for a negative cost, in a market economy[4] may be correct, and there is some corroborating evidence for the proposition.[5] However, Knight's claim was made in a time before we even recognized the problem of entrepreneurship in large, publicly held corporations where it is more likely that this function is being provided on a more or less conventional market basis. And, in all fairness, we should note that Knight did not claim that more compensation would not elicit more entrepreneurial services, only that we had received more entrepreneurial services than we had paid for.

[1] Kirzner, Competition and Entrepreneurship, University of Chicago Press 1973
[2] Uncertainty is so great that we cannot even assign an approximate risk of its happening. See Knight, Risk, Uncertainty and Profit, 1921
[3] Schumpeter, The Theory of Economic Development, 1911

[4] See, e.g., Hamilton, Does Entrepreneurship Pay? An Empirical Analysis of the Returns to Self-Employment, JPE 2000, vol. 108, pp. 604-631

Schumpeter had the somewhat peculiar notion that the large corporation could provide no way to compensate the entrepreneurial function and would, therefore, ultimately disappear into a bureaucratic black hole without innovation.[6] But large corporations are still here, even larger than when Schumpeter wrote, and we still do not live in this Schumpeterian static world. Entrepreneurship in the sense of discovery and unpredictable innovation is indisputably going on in the very large corporations, and it seems more likely that entrepreneurship is being compensated for, albeit not in a fashion captured in simple supply and demand models or taught in business school theories of executive compensation or envisioned in contracts-law casebooks. But the mere fact that we cannot account for this exchange in our double-entry bookkeeping or even in our advanced econometric techniques does not make the likelihood of some form of compensation any the less real.

The problem is not so critical if one thinks of the entrepreneurial services produced by an Edison or a Ford or a Gates. They were, in addition to being entrepreneurs under anyone's definition, capitalists, managers, inventors, risk takers, and employees of the companies they founded. Whether they became enormously wealthy because of their exercise of the entrepreneurial function or of the capitalist or managerial one is hardly of great social moment. But for myriad individuals otherwise connected with large, publicly-held corporations the problem can become acute. Indeed a good deal of the modern discussion of designing compensation plans to coordinate the interests of owners and managers is, in effect, a discussion of how to motivate entrepreneurial services, even though we rarely recognize it as such.

Business improvement and innovation may often be indistinguishable from normal good management, and yet the two are implicitly separate and distinct functions, one relating to the performance of a known function and the other the provision of something unpredictable. Furthermore, entrepreneurial contributions may be made by people both inside and outside the organization, by definition not possible for managerial functions.

[6] Schumpeter, Capitalism, Socialism and Democracy, 1946

And often we can not even recognize an entrepreneurial contribution, or its value, until long after it has occurred.

While we tend to think of entrepreneurial contributions as the large, creative-destruction type of changes, the truth is commonly very different. It may be the case that individual, discrete examples of entrepreneurship occur with enormous frequency, albeit in small or even barely noticeable increments. Discovering the incandescent lamp is one thing, but finding a new way to organize the inputs on an assembly line, clearly a candidate for being called entrepreneurial, will usually not receive that same degree of attention or acclaim, at least until it shows up on the proverbial bottom line. Even then the real source of the revenue gain may be difficult to specify. And it may take years for the stock market to register the new value created, since the increase in accounting earnings may be years away.[7] The stock market may be efficient, but it must have information inputs to do its job.

We do sometimes recognize the innovations of employees (but never of outsiders) with such compensation forms as bonuses, new grants of stock or stock options or increased salary. Some part of the equity forms of compensation, stock or stock options may also include a component for entrepreneurial actions. To that extent such compensation will have an ex ante motivating force for innovation. But it is unlikely that these forms of compensation, without reaching enormous size, can ever motivate an efficient[8] level of

[7] This is merely one of many reasons it would be better public policy to encourage early utilization of new information in the stock market instead of hindering, delaying and distorting it, as we now do. See Manne, The Welfare of American Investors, Wall Street Journal, June 13, 2006, p. A16: "The new approach would suggest that it is undesirable to have laws discouraging stock trading by anyone who has any knowledge relevant to the valuation of a security. Thus, assembly-line workers, administrative assistants, office boys, accountants, lawyers, salespeople, competitors, financial analysts and, of course, corporate executives (government officials are another story) should all be encouraged to buy or sell stocks based on any new information they might have. Only those privately enjoined by contract or other legal duty from trading should be excluded."

[8] We might debate about what the efficient level of entrepreneurial services is, since the function does not neatly fit into traditional economic analytics of efficient output. We can conceive of not having enough entrepreneurship (cf. many underdeveloped countries), but it is difficult to make sense of any concept of over-production of entrepreneurship, since all such services will have been either compensated for or given freely. Perhaps the sentence footnoted should refer to motivating entrepreneurial activity without reference to the amount as being efficient or not. But in the scheme of using insider trading to compensate entrepreneurial activity, as proposed below, there could never be such a thing as "too much" incentive,

entrepreneurial activity. Suffice it to say for now that they were never designed expressly with compensation for entrepreneurial services in mind. On that Schumpeter was certainly correct when he said that "the fact that personal gain, beyond salary and bonus cannot, in corporate business, be reaped by executives except by illegal or semi-illegal practices shows precisely that the structural idea of the corporation is averse to it." [9]

There are fundamental problems with each of these as forms of compensation to the corporate entrepreneur, though Schumpeter was undoubtedly too hasty in proclaiming the corporation incompatible with innovation. I dealt with this topic some years ago and will not repeat that discussion here.[10] For the most part the problem is that the settling up with bonuses or additional compensation is always done post hoc and, therefore, is subject to great disagreement about the amount, about who should get the extra compensation, about the correct evaluation of the individual's contribution or about whether any reward is appropriate at all. This problem may be especially acute because of the special psychological characteristics of great entrepreneurs, most notably optimism, that Knight so insightfully noted.[11]

Certain parts of the discussion I tried to initiate on this subject many years ago are perhaps more relevant today even than they were then. Consistent with the idea of the entrepreneur as a creator of new combinations and the discoverer of new ideas or information, a system of compensation is required that can more precisely measure the true present value of these contributions than can a compensation committee. Simply holding the company's stock, which we assume will accurately measure the value of the innovation, can never perform the appropriate reward function, since the value of the reward is shared equally, per share, with all other shareholders. Further, the amount of stock held by the entrepreneur will be determined long before the innovation occurs.

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since if the development is not worthy, it will not be reflected in a higher stock price and, therefore, will not reward the developer.

[9] Schumpeter, 1942, op. cit. pp. 157-59, but, as we shall see, the system does allow an appropriate form of compensation, insider trading, though Schumpeter may have included that among the illegal or semi-illegal forms of compensation. His failure to clarify this point has always been something of a mystery.

[10] See Manne, Insider Trading and the Stock Market, Chapter IX, 1966

[11] (Find page)

Only if the entrepreneur is also the owner of the bulk of the company's shares (thus combining two economic functions in one person) can this form of reward also be considered an appropriate form of compensation for the entrepreneur. But then we are talking about the likes of the early Ford or Edison examples and not about lesser mortals in modern publicly held companies.

Furthermore the idea of entrepreneurs receiving their reward via stock ownership misses another salient feature of true entrepreneurship. Stock ownership entails risk, which, as explained above, is not the hallmark of the true entrepreneur's interest. While stock price will more accurately than any other mechanism evaluate and price the contribution of the corporate entrepreneur, full exploitation of (in the sense of being rewarded for) new information developed by the entrepreneur can be achieved only by trading in the stock and not simply by holding it. We should anticipate that share trading rather than share holding would be the hallmark of the corporate entrepreneur in the large, publicly held company.

Thus, if the United States government had not progressively outlawed insider trading since 1961, we should expect to find [12]that the wealth of many individuals connected with large corporations, particularly but by no means exclusively those responsible for the progress and development of the business, is explained as much or more by share trading than by share ownership. But as insider trading has been increasingly demonized and criminalized, other forms of compensation have had to be substituted for this one, and the amounts required of these other forms of compensation, as discussed in more detail below, are apt to appear scandalously high in order to approximate appropriate compensation for entrepreneurs, another good example of the unintended and unforeseen consequences of regulation.

This analysis may also help explain a persistent conundrum in modern corporate economics: why are larger corporations, generally speaking, less entrepreneurial than

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[12] And the same is very likely true for pre-1961 companies, though no one to my knowledge has done the study.

smaller ones? Surely Schumpeter's pop-sociological theory that bureaucratic, risk-averse types will dominate large corporations is not a robust explanation. We see too many examples to the contrary. A more cogent answer flows directly from our assumptions regarding entrepreneurial personality, compensation and a little arithmetic.

As a corporation grows in absolute size, the effect of any given development on share price becomes less and less in absolute terms. That is, a billion dollar development in a publicly held corporation with a market capitalization of 50 billion dollars will have half the per share price consequence of the same development in a company with a 25 billion dollar capitalization. Thus, if entrepreneurs want large gains and small risk,[13] we should expect persons with true entrepreneurial personalities, that is with high confidence levels in Knight's terms, to be attracted to smaller corporations, where they can realize greater trading profits from the same level of contribution.

This theory does not preclude innovation and entrepreneurship in larger corporations; it merely suggests that smaller publicly held firms would, in the absence of rules against insider trading, have a comparative advantage in attracting employees with a more entrepreneurial bent. Thus another of the unnoticed and unintended consequences of insider trading regulation has been to discriminate against smaller publicly held corporations in relative favor of larger ones. The regulation, to the extent that it is effectively enforced, removes one of the most significant competitive advantages smaller companies have. This could help explain why there was no great hew and cry from America's top businesses when the SEC high-handedly wrote new law on insider trading in 1961.[14]

But even without the implicit subsidy to larger corporations from insider trading regulation, the larger firms still have means to compete for entrepreneurial employees. To compete effectively in the market for entrepreneurial talent with the smaller publicly

[13] A notion derived from both Knight's and Kirzner's view of the entrepreneur
[14] For more on why this development was met with silence, see Manne, Insider Trading: Hayek, Virtual Markets and the Dog that Did Not Bark, Journal of Corporation Law, Vol. 31, pp 167-185, 2005.

held companies, the larger companies would have to – and do - offer higher salaries and other perks than would the smaller ones. Thus we have a new explanation for the correlation often found between size of a company and the compensation levels of its executives. We may also have found a new and cogent, if partial, explanation for the apparently scandalously high salaries and other perks in large companies that have come to public attention in recent years. It takes a lot of straight salary to compensate an executive for the loss of the right to trade on new information that he or she creates or is allowed early access to. As Jensen and Murphy claimed many years ago the form of compensation may count for more than the level, though they did not consider insider trading in the mix.[15]

For these reasons and perhaps others, specific amounts of pay or stock will probably never capture the essential required characteristic of effective entrepreneurial compensation. The incentive system must appeal to the confident nature of the entrepreneur as well as to the entrepreneurial instinct to "cash in big" from new contributions. Facing a compensation committee's ex post evaluation after the fact of invention will hardly appeal to this type of personality. As we have seen, conventional compensation devices all suffer the problem of valuation of the innovation as well that of determining the person directly responsible for a new development and deserving of reward, matters about which the innovator and his or her employer will almost certainly disagree.[16]

Clearly the incentive to act entrepreneurially must exist in advance of the contribution and with an understanding that in fact nothing of value may be developed, another reason that it is so difficult to design an ex ante compensation system for entrepreneurial

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[15] "On average, corporate America pays its most important leaders like bureaucrats. Is it any wonder then that so many CEOs act like bureaucrats rather than the value-maximizing entrepreneurs companies need to enhance their standing in world markets?" Jensen and Murphy, Performance Pay and Top-Management Incentive, The Journal of Political Economy, Vol. 98, No. 2 (Apr. 1990), pp. 225-264.

[16] As well they should. These matters involve inherent uncertainty, and it can be safely predicted that mistakes, appraised ex ante, will appear. The insider trading compensation device does not entirely dispense with these errors, but it does generally compensate for entrepreneurial activity while doing away with the disagreements and personal involvements in compensation decisions. And it does no harm and entails some other real benefits in the process. See Manne 1966, op.cit.

developments in a large corporation. Compare in this sense the research scientist who is hired to invent or develop something, a cure for cancer for example, the outcome of which research is inherently uncertain. There obviously can be no guarantee of the results of such research, and yet the compensation must be sufficient to entice the person to do the work. A salary plus the right to trade in the stock market on any new information produced will neatly satisfy the requirements of an appropriate compensation system for this kind of effort. Furthermore, the incentive should ideally be able to go to any individual in the corporate system who might, whether predicted to or not, make an entrepreneurial contribution. In a sense it is a personality trait that the employer wants and not necessarily or exclusively an individual of known propensities, though that too must occur. Allowing trading on new information produced will again satisfy this requirement.

So an entrepreneurial compensation system must possess some unusual characteristics if it is to successfully attract the sought after services. It must appeal to the personality of the entrepreneurial type; it must avoid valuation and attribution issues post hoc; and it must ideally motivate any prospective employee to perform as an entrepreneur. It is impossible to find a system that will do all this other than the right of corporate employees with valuable new information to buy shares on that news in advance of public disclosure.

Insider trading as a form of compensation also has some peculiar characteristics that will distinguish it analytically from other forms of compensation. The most obvious difference is that the value of individual stock trades to be made in the future cannot by their nature be determined in advance, even though, as noted earlier, a real market value must attach to a general right to engage in insider trading. It cannot be assumed, even with the most efficient stock market, that the profits from trading on inside information will correctly and precisely measure or evaluate a corporate entrepreneurs contributions, even though in some cases this may happen. Obviously the amount of stock the insider is willing to purchase on the information that he or she created or learned will vary with a number of exogenous circumstances, including the availability of credit to the employee[17] and the certainty of the information's value. Further, stock market prices at any given moment reflect a variety of other inputs, so that it will always be difficult to isolate and measure the value of one particular entrepreneurial development. And trading quickly, i.e. buying and then selling right after the disclosure, merely reduces the risk of stock holding; it does not remove it entirely.

Still insider trading is the system par excellence of compensating entrepreneurs in large corporations, and it does not matter one whit that the amount the employee realizes by his or her trading is far more or less than the contribution is worth, that the wrong person may be rewarded with this right,[18] that profit can be made from bad news as well as good news or that the system might seem unfair to economics-challenged regulators and moralists. There are, of course, myriad other considerations in the insider trading debate, and the present discussion is limited to the appropriateness of insider trading as a form of entrepreneurial compensation in the large, publicly held corporation.[19] To date no one has addressed critically the entrepreneurial compensation argument which I offered in substantially these terms 43 years ago, though several have acknowledged the value of the right to trade on undisclosed information as a form of compensation.[20]

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[17] This point implicates the discussion in my 1966 book of investment bankers performing some sort of clearinghouse function for new information, thus allowing corporate entrepreneurs to virtually trade information with other corporate entrepreneurs through time and trade knowledgably in the stock of various companies instead of going heavily into debt in order to fully exploit one significant piece of information. See Manne 1966 op. cit. pp. 69-71.

[18] There are after all other advantages to this system too, but they are not being discussed here. See generally Manne 1966 op.cit..

[19] The "mea culpa" I entered in my 2005 article, op. cit. referred only to the problem of trying to design an executive compensation plan in advance utilizing the right to trade in shares as an explicit part of the package. I in no way intended to retract the idea that a general rule of allowing insider trading was the best device we could imagine for appropriately compensating for entrepreneurial services in the publicly held corporation.

[20] The following suggest that, under certain conditions, insider trading can serve as an efficient compensation mechanism but none makes a distinction between entrepreneurs and managers: see Bebchuk and Fershtman, *The Effects of Insider Trading on Insiders' Effort in Good and Bad Times*, 9 EUR. J. POL. ECON. 469 (1993); Carlton and Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1983); Dye, *Insider Trading and Incentives*, 57 J. BUS. 295 (1984); Hu and Noe, *Insider Trading and Managerial Incentives*, 25 J. BANKING & FIN. 681 (2001).

It should be noted here that the use of insider trading rights as a form of compensation has the double advantage of applying to everyone, either within or outside the company, since the incentive will have a generalized effect on all employees and related outsiders – if nothing else by influencing the general corporate culture - and not merely on those who might be explicitly described as an entrepreneur. In that sense it is perhaps a little misleading to refer to insider trading as a form of compensation for any specific individual. It is an incentive device available to anyone, especially employees who chooses to take advantage of it, and it will go a long way towards producing a corporate culture of innovation. That, after all, is what is wanted, not some new provision to add to the standard form employment contract. And while such a corporate culture may generate considerable employee attention to the stock market, that actually should be seen as a part of the solution not a part of the problem.

Today with the regulation, criminalization and vilification of insider trading many, probably most corporate employees - particularly the entrepreneurial ones who would be the easiest for regulators to spot - would try profit from a new idea by trading in the stock market before disclosure. But along with that hesitation to trade undoubtedly goes a loss of incentive for developing new ideas and certainly the loss of a culture that could be said to encourage entrepreneurship. It is inconceivable that the outlawing of insider trading in the United States has not had a significant deleterious effect on the long-term performance of our publicly held companies.

Two factors have prevented this bit of "fairness" regulation from totally destroying large corporate enterprise in the fashion Schumpeter predicted. The first is that, at least until recently, we did not consider controlling the level of other forms of compensation which might (inefficiently and expensively) substitute for insider trading as an incentive system for entrepreneurial services. The other is the impossibility of full enforcement of laws against insider trading. While the publicity motivated prosecutions and the propaganda system that have long characterized the SEC's campaign against insider trading deter some people from engaging in the practice, all indications are that it still flourishes, perhaps even by the right people sometimes. Rarely is there a major news story about a corporation without prior movement in the indicated direction in the stock market. Someone is cashing in on the development; it would certainly be to everyone's benefit if it were the people responsible for it.