For showing how contracts work best, two economists win Nobel

October 10 2016, by Paul Wiseman And Karl Ritter

In this Nov. 2, 2015 file photo, Finnish Professor Bengt Holmstrom of Massachusetts Institute of Technology attends a business seminar in Helsinki, Finland. Bengt Holmstrom and Oliver Hart on Monday Oct. 10, 2016, win the Nobel Memorial Prize in economic sciences. (Jussi Nukari/Lehtikuva via AP, File)

Let insiders easily cash in stock options, as Enron did, and you risk seeing executives abandon a failing company. Encourage contractors to sacrifice quality to cut costs and you might cause problems like those that led the U.S. Justice Department to phase out privately run prisons.

Designing contracts is a tricky business. For their groundbreaking work on how to make contracts fairer and more effective, Oliver Hart of Harvard University and Bengt Holmstrom of the Massachusetts Institute of Technology won the 2016 Nobel prize for economics Monday. They will share the 8 million kronor ($930,000) award for their contributions to contract theory.

For decades, the two men have studied practical problems involving the countless kinds of contracts that underlie modern commerce:

How should companies pay their executives? What types of tasks should government agencies outsource to private contractors? How best to write an auto insurance policy to protect drivers from financial loss without lulling them into carelessness?

Pay packages, Holmstrom's work suggests, are best tailored to avoid either punishing or rewarding CEOs for happenings beyond their control.

"You don't want to reward the CEO because the S&P 500 (stock index) has gone up 20 percent," said Patrick Bolton of Columbia University Business School, who studied under Hart and has written a textbook on the economics of contracts. "You want to reward the CEO when his company outperforms the S&P."

From left, Tomas Sjostrom, member of the Committee for the Prize in Economic Sciences in memory of Alfred Nobel, Goran K. Hansson, Secretary General of the Royal Swedish Academy of Sciences and Per Stromberg, Chairman of the Committee for the Prize in Economic Sciences in memory of Alfred Nobel, attend a press conference to announce Oliver Hart and Bengt Holmstrom as the winners of the Nobel Memorial Prize in economic sciences. (Stina Stjernkvist/TT via AP)

Likewise, companies fare best when they establish pay packages that incentivize executives to prioritize the long term as much as the short term, to avoid focusing too much on quarterly profit expectations.

"These kinds of insights into how we should design contracts are very important because we don't want to give the wrong incentives to people," said Tomas Sjostrom, a member of the Nobel committee. "We don't want to reward them for things that they were not responsible for. We want to reward the right thing."

Hart, 68, is a London-born U.S. citizen who has taught at Harvard since 1993. Holmstrom, 67, is an academic from Finland who formerly served on the board of the country's mobile phone company Nokia. Economists who have long known the two men and their work offered warm praise Monday.

"This is the Nobel Prize in economics at its best," said George Akerlof of Georgetown University, who won the prize in 2001. "The character of both Bengt and Oliver shines through in their work and their character: They are true intellectuals and truly great people."

In this photo provided by Harvard University, Oliver Hart, the Andrew E. Furer Professor of Economics at Harvard, reads congratulatory emails at his home in Lexington, Mass., Monday, Oct. 10, 2016, after winning the Nobel prize in economics. Hart and Finnish economist Bengt Holmstrom, of the Massachusetts Institute of Technology, share the award for their contributions to contract theory. (Jon Chase/Harvard University via AP)

At a news conference at MIT, Holmstrom declined to say whether he thought CEO pay—a hotly contentious issue in the United States and elsewhere—had become excessive.

"It is somewhat demand and supply working its magic," he said.

But he said companies can give executives the wrong incentives, as the energy firm Enron did, when it allowed insiders to unload their stock options as the company fell into a death spiral.

"The problem wasn't options," Holmstrom said. "The problem was the way people could sell out."

In this Nov. 2, 2015 file photo, Finnish Professor Bengt Holmstrom of Massachusetts Institute of Technology attends a business seminar in Helsinki, Finland. The Nobel Memorial Prize in economic sciences has been awarded to Oliver Hart and Bengt Holmstrom on Monday Oct. 10, 2016. The Nobel jury praises the winners "for their contributions to contract theory." (Jussi Nukari/Lehtikuva via AP, File)

The Internal Revenue Service used Hart as an expert witness in cases involving Black and Decker and Wells Fargo. At issue was whether some of the companies' transactions had had a legitimate corporate purpose or had been designed just to reduce their tax bills.

Robert Gibbons at MIT's Sloan School of Management notes that the term "contract theory" might make Holmstrom and Hart's work sound narrower than it is. But, Gibbons explained, their research goes well beyond legally binding contracts. They have analyzed the practical arrangements worked out between many disparate players—partners within a law firm, say, or companies and their suppliers or government agencies and private contractors.

Gibbons says Holmstrom and Hart's work is just now beginning to have a practical effect as it evolves from academic research to management training to real workplaces.

"The real-world stuff is coming," he said. "You're starting to see it."

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In his writing, Hart has expressed concern about private prisons: Would profit-seeking contractors overemphasize cost-cutting over maintaining quality?

His concerns proved perceptive: After discovering that private prisons were marred by more safety and security problems than government-run ones were, the Justice Department in August ordered the Bureau of Prisons to reduce and eventually end the use of private prisons.

The economics prize is not an original Nobel Prize. Formally called the Nobel Memorial Prize in Economic Sciences, it was added to the others in 1968 by Sweden's central bank.

The Nobel Prizes in medicine, physics, chemistry and the Nobel Peace Prize were announced last week. This year's Nobel announcements will end Thursday with the literature award. The laureates will collect the awards on Dec. 10, the anniversary of prize founder Alfred Nobel's death in 1896.

The media wait for a press conference at the Royal Academy of Sciences in Stockholm on Monday Oct. 10, 2016. The Nobel Memorial Prize in economic sciences has been awarded to Oliver Hart and Bengt Holmstrom on Monday Oct. 10, 2016. The Nobel jury praises the winners "for their contributions to contract theory." (Stina Stjernkvist/TT via AP)

At Harvard, Hart said it "means a lot" to share the prize with Holmstrom.

"I'm glad I won it with him," Hart said. "It's going to be fun to celebrate in Sweden with him."

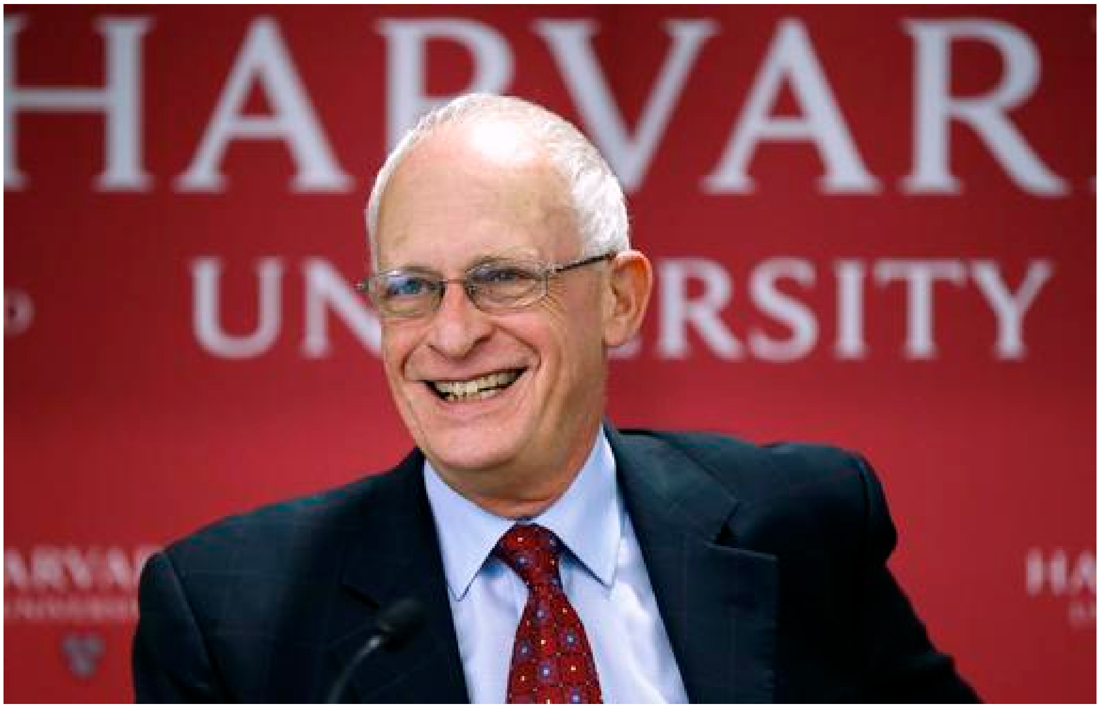
Oliver Hart, the Andrew E. Furer Professor of Economics at Harvard, speaks on the phone at his home in Lexington, Mass., Monday, Oct. 10, 2016, after winning the Nobel Prize in economics. Hart and Finnish economist Bengt Holmstrom, of the Massachusetts Institute of Technology, share the award for their contributions to contract theory. (AP Photo/Michael Dwyer)

Oliver Hart, the Andrew E. Furer Professor of Economics at Harvard, poses at his home in Lexington, Mass., Monday, Oct. 10, 2016, after winning the Nobel Prize in economics. Hart and Finnish economist Bengt Holmstrom, of the Massachusetts Institute of Technology, share the award for their contributions to contract theory. (AP Photo/Michael Dwyer)

Oliver Hart, right, the Andrew E. Furer Professor of Economics at Harvard, and Nobel laureate Eric Maskin, economics 2007, also from Harvard, laugh together following a news conference at Harvard in Cambridge, Mass., Monday, Oct. 10, 2016. Hart and Finnish economist Bengt Holmstrom, of the Massachusetts Institute of Technology, shared the 2016 Nobel Economics Prize for their contributions to contract theory. (AP Photo/Michael Dwyer)

Oliver Hart, the Andrew E. Furer Professor of Economics at Harvard, speaks during a news conference, Monday, Oct. 10, 2016, at the university, in Cambridge, Mass., after winning the Nobel Prize in economics. Hart and Finnish economist Bengt Holmstrom, of the Massachusetts Institute of Technology, share the award for their contributions to contract theory. (AP Photo/Michael Dwyer)

Oliver Hart, left, the Andrew E. Furer Professor of Economics at Harvard, sits with his wife, Rita Goldberg, before speaking during a news conference at Harvard in Cambridge, Mass., Monday, Oct. 10, 2016, after winning the Nobel Prize in economics. Hart and Finnish economist Bengt Holmstrom, of the Massachusetts Institute of Technology, share the award for their contributions to contract theory. (AP Photo/Michael Dwyer)



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Finnish Professor Bengt Holmstrom of the Massachusetts Institute of Technology faces reporters during a news conference, Monday, Oct. 10, 2016, on the campus of MIT in Cambridge, Mass. The Nobel Memorial Prize in economic sciences was awarded Monday to Oliver Hart and Holmstrom, who will share the prize. The Nobel jury praised the winners "for their contributions to contract theory." (AP Photo/Steven Senne)