

by Gene Steuerle

Chinese Accounting for Stock Options

For a long time I have tried to remain open on the issue of valuing stock options. I know that despite modern finance theory they can be hard to value perfectly, due mainly to their unusual and asymmetric risk structure and lack of open trading in the market. I have listened patiently to all the arguments of start-up companies who complain that it is somehow harder to give restricted stock than stock options to their executives. I know that valuation for financial purposes and for tax purposes are not exactly the same policy issue. Still, none of this offsets my fundamental distaste for accounting badly for income, a distaste that derives in no small part from my experience with Chinese accounting as it had evolved in the 1960s and even the 1970s.

You see, by the height of China's unification under a communist rule, Mao and his underlings had decided that income accounting just wasn't that important. They even concluded that for all intents and purposes they didn't need an income tax system, one of the obvious tools of capitalism. The country combined the worst aspects of its ancient dynastic and modern communist systems and was largely run on the basis of the corrupt bargain. I say "corrupt" not so much in the sense that all bargains and agreements were illegal, although one guesses that many were; rather, they inevitably corrupted integrity and spirit. The state officials in agency X went to company Y, where they sat for months figuring out how many widgets would be produced and which share of a quota of inputs would be obtained from yet another factory. Then after allocating food and housing and some cash to the rank and file workers — a person who was a good communist and didn't exceed his quota of children might be favored — they bargained with the executives in each firm over who would get the better housing, the maid service, and the special privilege to ride in an automobile "owned" by the state.

Committees would gather to figure out how to pull together all these inputs and outputs and what to do when other firms didn't meet their quotas. Communists thought they were sophisticated because they sometimes used economic input-output models in place of markets and market prices. There was planning everywhere, so that must mean progress, right? Everything was bargain-driven, and you had better believe that *who* you knew made a lot of difference in *what* you got.

Of course, in this process firms had little idea of their real income or profit since prices were largely set by the state. Individuals were in the same boat: few had any idea of their rate of compensation, and bosses with all sorts of special privileges — let's not forget the free

vacations at state-run resorts — hid their income from both their workers and themselves.

When China decided to reverse gears at the end of the 1970s and run firms more on the basis of a "profit" motive, it had to start measuring income again. It even set up a modest income tax, which is hard to enforce to this day given practices that have built up over the years. One major complication in this new world was that for many people much of the income was in the form of in-kind benefits that were hard to evaluate. Not only did people not even think about a state-granted apartment as "income" or compensation, they wouldn't value it as highly as the cost to the state.

In the end, of course, few had any idea what a firm's income was, what each worker earned, or which parts of the firm were profitable and which were not. They certainly didn't know the net profitability of the enterprise, or account for the impact on the bottom line of many payouts promised for the future. Having bargained their way to the top of this system, many executives didn't really want to know, and they fought against instituting a market system after they had climbed up the pyramid of success under a bargaining system.

Over the years, various interest groups in the U.S. have put forth innumerable stories explaining why good income accounting for financial or tax purposes just isn't required for what they are doing or the income they are receiving. Those who don't want to value stock options are only the latest in a long line of such advocates. Like the former Chinese executives, they complain about what is hard to measure rather than try to set up compensation schemes and other alternatives that would be easier to measure. On one side of the Pacific, they don't want cash bonuses rather than new low-rent apartments, while on the other side they protest restricted stock grants in place of stock options. But many on both sides fail to admit the full story — how inaccurate accounting for income is likely to lead to the misallocation of resources in the firm and in society, thus leading to an actual decline in national output. Nor do they always "fess up" to the fact that there may be tax advantages from not recognizing the income currently or accurately — sometimes because delay can make a difference, sometimes because some of the income is excluded from an income or wage tax.

One wonders about the extent of belief in the market among those fighting against current valuation of stock options. The market allocates more efficiently on the basis of good current information, and they either reject this basic market principle or, at a minimum, believe that the cost of incomplete information is worth paying. But, then, they do contribute a lot to politicians who oppose accounting rules put forward by groups attempting to represent the public. Now there's a real market.