Paying Workers More to Fix Their Own Mess

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By David Leonhardt
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We cannot attract and retain the best and the brightest talent to lead and staff the A.I.G. businesses — which are now being operated principally on behalf of American taxpayers — if employees believe their compensation is subject to continued and arbitrary adjustment by the U.S. Treasury.

— Edward Liddy, chief executive, American International Group

Ah, retention pay. It has been one of the great rationales for showering money on chief executives and bankers regardless of how well they are doing their jobs. It's just that the specific rationale keeps changing.

In the booming 1990s, companies supposedly had to pay retention bonuses because executives had so many other job opportunities. There was a war raging — a war for talent, said McKinsey & Company, the consulting firm.

Then came the aftermath of Enron, when new scrutiny and regulations apparently made some chief executives wonder if they still wanted their jobs. "I'm thinking of actually getting out," David D'Alessandro, the head of John Hancock Financial Services, reported hearing from one fellow chief executive. The antidote to such doubts? Retention pay, obviously.

Now comes Mr. Liddy, the government-appointed chief of A.I.G., defending multimillion-dollar bonus payments for the people who run the small division that brought down the company. If the government doesn't let them have their money, they will walk away, Mr. Liddy says, and nobody else will know how to clean up their mess.

We'll get to the merits of his argument in a moment, but it's first worth considering the damage that the current system of corporate pay has wrought. The potential windfalls were so large that executives and bankers had an incentive to create rules that would reward them no matter what. The country is now living with the consequences.

So any attempt to build a new financial system, one that's less susceptible to bubble, bust and bailout, will have to include a new approach to pay. Yes, the issue is thorny. Some past attempts to rein in pay have ended up being feckless or even counterproductive. But that is no reason to give up.

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Nothing highlights the fiction of performance-based pay quite so well as retention bonuses. It turns out that, at least for chief executives, retention bonuses are almost entirely unnecessary.

A few years ago, when the economy was still expanding, I looked into every large company that had changed chief executives over the previous six months. Not a single boss at any of them had left for another job. Such departures are so rare that Booz & Company's annual study of executive turnover doesn't even include a category for them. The benefits of the job — the pay, the perks, the gratification that comes from running a company well — are too good to leave, even for a similar job.

The situation is a little different for jobs below the top level, particularly on Wall Street. Surely, if the employees of A.I.G.'s notorious financial products division were to be denied their bonuses — a big chunk of their annual compensation — many might leave.

The nub of Mr. Liddy's argument is that these departures would be a terrible thing. But there are several weaknesses with this argument.

The first is that the original explanation for these bonuses was rather different. When they were devised in early 2008, months before the first bailout, as Mr. Liddy's letter to the government on Saturday explained, "A.I.G. Financial Products was expected to have a significant, ongoing role at A.I.G." The idea, he said, was to guarantee "a minimum level of pay for both 2008 and 2009." So the rationale for A.I.G.'s retention bonuses is as malleable as the rationale for chief executives' bonuses.

Most amazingly, the A.I.G. bonuses haven't even accomplished their stated goal. Andrew Cuomo, New York's attorney general, said Tuesday that 52 employees who received bonuses had since left A.I.G.

The second problem with Mr. Liddy's argument has to do with Mr. Liddy himself. His defenders have noted that the government brought him out of retirement to fix A.I.G. and that he presumably puts a higher priority on doing a good job than pleasing A.I.G.'s employees.

And he probably does. But he is also a product of the current, broken executive pay system. As the chairman of Allstate from 1999 to 2007, when the company's stocks underperformed those of its rivals, he made $137 million. Almost $14 million of that, according to the Corporate Library, came in the form of stock that the company called a "a tool for retaining executive talent." Which means Mr. Liddy may not be entirely objective about retention bonuses.

Finally, there is the question of how hard replacing those A.I.G. employees would be. Certainly, some of them must have particular insight into unwinding the toxic portfolio they built. But I doubt that anywhere near all 418 financial products employees — who have received bonuses worth $395,000 on average — are indispensable.

Simon Johnson, a former chief economist at the International Monetary Fund, has pointed out that in financial crises, bankers often exaggerate the difficulty of cleaning up their mess. They do so partly to justify their own continued importance and also to fight off calls for a government takeover of banks. In reality, Mr. Johnson says, the mechanics of cleaning up hobbled banks turned out to be fairly straightforward during other recent crises, like the Asian one in the '90s.

It’s entirely understandable, then, that the Obama administration, the Federal Reserve and Congress are looking for creative, legal ways to claw back some of the bonuses. That bonus money is really taxpayer money: absent a bailout, no A.I.G. would exist to pay bonuses.

The larger question is how to change the rules on corporate pay to reduce the odds of future crises. Throughout this crisis, policy makers, starting with President George Bush and Ben Bernanke and now including President Obama, have been a bit too deferential to Wall Street. That deference has fed populist anger, which threatens the political viability of the necessary continuing bailout of the credit markets.

The bonus scandal offers Mr. Obama and Mr. Bernanke a chance to get ahead of the curve — so long as they come up with changes that extend well beyond A.I.G.

The starting point would be a rigorous analysis of whether the government can take specific steps to restrain pay. Some thoughtful management experts think any such efforts are doomed to fail. Others are more optimistic. “There are ways to do it,” says Lucian Bebchuk, a Harvard Law professor.

Across-the-board caps on pay don’t make sense. But perhaps the government can prevent companies from claiming a corporate tax deduction on any pay above a certain threshold. The current limit, which is $1 million, applies only to base salaries and thus has little meaning. Or perhaps companies can be penalized if they pay bonuses based on short-term profits, as A.I.G., Lehman Brothers and just about every other company recently has. The Fed made a suggestion along these lines recently, but it didn’t do anything more than ask nicely.

If no such ideas proved workable, there is still one more option. Today’s tax code makes no distinction between income above $373,000 and income above, say, $5 million. Both are taxed at 35 percent.

That is a legacy of the tax changes of the early 1990s, when far less of the nation’s income went to millionaires. Today, you can make a good argument for a new, higher tax bracket on the very largest incomes. In the past, the economist Thomas Piketty says, higher marginal tax rates tended to hold down salaries and bonuses, because executives had less incentive to angle for multimillion-dollar pay.

Do these ideas stem in part from anger and bitterness? Of course they do. How can you not be a little angry and bitter about the role that huge, unjustified pay played in causing the worst recession in a generation?

In fact, that’s sort of the point. Given the damage that’s been caused by our decidedly unmeritocratic system of paying executives, the most irrational course of all would be the status quo.

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