Pay Check

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A few months ago, when Democrats proposed letting workers form unions without elections, Republicans recoiled in horror, issuing ringing paeans to workplace democracy. "After two hundred-plus years of our American democracy, it is breathtaking to see the right to a secret ballot rejected so flatly and so strongly," said Representative Howard P. "Buck" McKeon, in a typical example of the Jeffersonian rhetoric then coursing through Washington.

Today, Democrats are proposing to let a company's shareholders hold an advisory vote on how much they pay their CEO. Sounds democratic, right? Alas, much as it has in the Middle East, the GOP has grown weary of democratization. "This is Congress beginning to intrude on corporations," warned Representative Spencer Bachus. Keep in mind that the bill does not set limits on CEO pay. It does not even give stockholders the right to directly set compensation for their CEO. (Heaven forbid. That would be socialism. Or, well, free-market capitalism.) The bill merely gives shareholders the right to hold a *nonbinding* vote on whether the CEO--who, after all, works for them--is getting paid too much. But President Bush has promised to veto even this meager step.

The reason for the bill is that there's an abundance of evidence that CEOs get paid too much. Not too much in the "why do teachers earn 35,000 dollars a year while CEOs earn five hundred times as much" sense, but too much in the sense that their compensation doesn't reflect their actual economic value. In 1976, the average CEO compensation was 36 times that of the average worker, and it was 369 times the worker average in 2005. The rise in CEO pay vastly exceeds the rise in value of the companies they run.

To free-market purists, it's axiomatic that, if CEOs are taking home an ever-larger share of corporate income, they must be producing that much more value for their firms. "Clearly the top-performing CEOs in corporate America earn every penny of their compensation and then some," wrote Dick Armey in an op-ed that ran in *The Washington Times* on March 9 (and then--evidently due to a strong demand for CEO apologists--again on March 11).

But there's an alternate theory explaining the explosive rise in CEO pay. It holds that the boards of directors, which set CEO pay, don't perfectly represent shareholder interests. Board members are sometimes appointed by CEOs or are CEOs themselves. Their incentive to please the CEO by keeping his compensation high is greater than their incentive to please shareholders by keeping it low. Indeed, being too tough on a CEO could jeopardize their chances of getting future appointments.

Above all, board members are social beings, not perfectly rational maximizers of investor utility. They often belong to multiple boards and don't expend much time bargaining down CEO pay on behalf of shareholders. They identify with the CEO and will go along with overly generous pay

unless it's so huge it provokes outrage. Their standard method is to set pay by looking at the industry average and going a little higher. (Everyone wants to think *their* executive is above-average.) The result is a cycle of ever-rising CEO pay.

Harvard's Lucian Bebchuk and Berkeley's Jesse Fried have found lots of evidence supporting this theory. The two have looked at all the factors one would associate with a weak board of directors--the CEO is a director of the board, or a member, or the members serve on several boards--and all of them correlate with higher CEO pay. The discovery that executive compensation is dependent not just on supply and demand but on the independence of the board of directors helps explain lots of facts that the pure free-market model can't--unnecessarily complicated pay schemes, bonuses to fired executives who were owed nothing, et cetera.

This theory is the basis for the House bill giving shareholders the right to a vote on executive pay. A nonbinding vote would give shareholders a chance to express dissatisfaction with exorbitant pay and shame compensation boards into doing their jobs. Great Britain and Australia have this arrangement, and it has curtailed the worst abuses.

Republicans, though, warn that letting shareholders hold even a symbolic vote would have all sorts of dangerous effects. "The regulation, criticism, and hounding of public-company CEOs may have a major cost," fretted Steven Kaplan, a University of Chicago professor, testifying at a hearing two months ago. "CEOs can and will leave public companies to do something else."

The poor dears. The average CEO of a Standard & Poor 500 company earns nearly $15 million a year. I thought this would make it worthwhile to suffer perhaps some very occasional criticism from the people who pay their salaries. But apparently beneath the image of the hard-charging chief executive lie some very delicate flowers.

Fellow Republican Mike Castle of Delaware, whose management-friendly bylaws have lured more than half of all public companies to incorporate there, worries that "activist institutional investors, who may have their own political and social agendas" would get "more influence." And GOP Representative Randy Neugebauer warns that "this impulsive legislation can only distract shareholders from their true power--which is the power to pull their investment from any company that acts recklessly in deciding executive compensation." In sum, investors are hippie freaks and as distractible as small children.

The funny thing is, conservatives usually glorify investors--or, in their creepy Marxist phrase, "the investor class." It's not unusual for them to straightforwardly pledge to advance the interests of this favored class. "Bush recognizes that the investor class is the most important demographic group in the country," Grover Norquist said in 2003, celebrating tax cuts for stockholders. Just last week, a *Wall Street Journal* editorial warning against a potential tax hike on capital was titled "an assault on the investor class."

But these shows of comradeship are reserved for those instances when investors' interests clash with non-investors--i.e., the poor schlubs who don't own any stocks. When the heroic investor class bumps up against the even more heroic (which is to say, vastly wealthier) CEO class, the dialectic suddenly changes. Doesn't class solidarity count for anything these days?