C.E.O.'s Don't Need to Earn Less. They Need to Sweat More

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One recent Thursday, G. Steven Farris, the chairman and C.E.O. of the poorly performing oil-and-gas company Apache, stood before a few hundred shareholders who were about to vote on his salary. Farris, who was hoping to earn well over $10 million for this year, listed a number of his accomplishments. "We're the No. 1 driller in the Permian Basin," he said, referring to the oil reserves in West Texas and New Mexico. But some shareholders, most likely mindful of the company's falling stock price, noted that the proposed pay package seemed out of whack. Still, the tally was a nail-biter: 49.8 percent of the votes favored giving Farris the bump.

Most C.E.O.'s used to be able to handle their pay negotiations in private, but the Dodd-Frank reforms, which were passed in 2010, now give shareholders the right to vote on executive compensation. This has helped usher in a so-called "say on pay" revolution, which tries to stop executives from making more money when their companies don't do that well. In Switzerland, a recent nationwide referendum, passed 2 to 1, gave shareholders the right to restrict the pay for the heads of Swiss companies. The European Union is likely to vote on a similar measure by the end of the year.

C.E.O.'s like Farris have long argued that they should make more money, but what's surprising is that many business-school professors make the case even more energetically. The standard defense is that a talented marketing director or chief engineer can help a company thrive, but the next-best candidate will probably be successful, too. A great C.E.O., they say, is many times better than an average one, and those great ones need high-powered incentives. C.E.O.-friendly economists also suggest that the salary is moot if the chief executive is creating many multiples of their pay in shareholder value. Some of these enthusiasts point out that Steve Jobs rescued Apple (after his exodus) in 1997, when it was near bankruptcy, and turned it into one of the most valuable companies ever. Jobs was worth an estimated $7 billion at his death, but he made hundreds of billions of dollars for his shareholders. Many now say he was underpaid.

C.E.O.'s might indeed need significant incentives, but the problem is that most of them don't perform like Steve Jobs even when they get them. The financial research firm Obermatt recently compared the compensation of C.E.O.'s at publicly traded firms and their performance and found no correlation between the two. Like a bottle of wine or a promising college quarterback turning pro, C.E.O.'s are similar to what economists call experience goods: you commit to a price long before you know if they're worth it. Just ask the shareholders of J.C. Penney, which ousted its C.E.O., Ron Johnson, less than 18 months after hiring him away from Apple. Under his leadership, the company lost more than $500 million in a single quarter.

So far, the "say on pay" revolution feels more like the second season of "Game of Thrones" — there's a lot of drama, a bit of blood, some cheers, but things end up more or less exactly where they started. While the Dodd-Frank law requires a shareholder vote on executive pay at least

every three years, the vote is not binding. Apache's board eventually lowered Farris's package by around $3 million, but it is the exception. Shareholders ended up approving pay packages around 97 percent of the time. A vast majority of overpaid C.E.O.'s, it seems, have little to fear from all these new guidelines.

Economically speaking, this is more than a little odd. Shareholders should be motivated to pay their C.E.O.'s according to their success. But doing so involves a tricky dance known to game theorists as the principal-agent problem: how does an employer (the principal) motivate a worker (the agent) to pursue the principal's interest? This principal-agent problem is everywhere. (Do you pay a contractor per day of work or per project? Do you pay salespeople by the hour or on commission?) It becomes particularly thorny when the agent knows a lot more about his job than the principal. George Costanza was a comic incarnation of the principal-agent problem. He constantly invented schemes to make his employer think he was doing his job well when he wasn't doing much at all. "When you look annoyed all the time," he once told Jerry and Elaine, "people think that you're busy."

Boards and chief executives don't often suffer from Costanza-like ineptitude, but they are harder to rein in. They are often rewarded when they don't succeed but are not usually penalized enough when they do a lackluster job. Lucian Bebchuk, a professor at Harvard Law School and perhaps the leading academic voice for corporate reform, told me that the problem isn't (just) greed. It's the boards of directors. The directors are supposed to represent the stockholders' interests, he says, but most public firms, where C.E.O.'s can have considerable influence over board appointments, neuter those interests. They are structured so that a board tends to side with its chief.

Excessive C.E.O. pay, Bebchuk says, is a manifestation of a deeper problem. A bad C.E.O. pay package can cost shareholders millions; a corporation that is being poorly overseen by its board can cost billions. "Shareholder rights in the U.S. are still quite weak relative to what they are in other advanced economies," he explained. His solution is to pass laws that make it easier for shareholders to vote out boardmembers who fail to discipline underperforming chief executives. This, he argues, will motivate them to push back against executives that do an underwhelming job. At the very least, all the attention would keep boardmembers and C.E.O.'s on their toes. And a multitude of better-run companies would result in billions, perhaps trillions, of wealth returned to the economy.

On some level, Adam Smith offered a similar solution a long time ago. In "The Wealth of Nations," published in 1776, Smith argued that narrow self-interest — the precursor of high-powered incentives, perhaps — could lead to the best collective outcome, but he noted that greed alone isn't enough. Businesspeople needed a carrot (lots of money), he said, but they also needed a stick (the fear of being outcompeted). The modern public company, Bebchuk and many others argue, has damaged Smith's core principles. A C.E.O. protected by an overly cozy board (or, in frequent cases like JP Morgan, where Jamie Dimon is both C.E.O. and chairman of his own board) gets rich if he succeeds but is not penalized when his performance is, well, meh.

This is not only maddening; it's not even capitalism. Adam Smith saw this coming too. He warned that a new innovation, the joint stock company, skewed incentives because those who run a company aren't the ones who own it. "Negligence and profusion, therefore, must always

prevail, more or less, in the management of the affairs of such a company," he wrote. Fortunately, Bebchuk says, public companies have outperformed Smith's grim predictions, but they've also underperformed their potential. The solution is simple. Whether it's Jamie Dimon or George Costanza, capitalism works only when people are truly anxious, not faking it. C.E.O.'s need to be afraid that shareholders will cut their pay if they don't do better.