Letter From America: Critic of High C.E.O. Pay Is Vindicated

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NEW YORK — If you're like me, the hot-button issue of exorbitant pay for corporate executives is mainly a moral one, a matter of values. Those bloated, and, possibly, soon-to-be-regulated pay packages of American C.E.O.'s illustrated what might be called the plutocratization of American life — a glorification of money as the chief ingredient of success.

But if you're Lucien Bebchuk, professor of law, economics and finance at the Harvard Law School, and a man recently described in The New York Times as waging a "crusade" against the way corporate wages are paid, the moral question is secondary to a practical one.

"I'm not a crusader by nature," Mr. Bebchuk, who was born in Poland and raised in Israel, said in a phone interview this week. "I got into this subject by intellectual interest." It was an interest, moreover, that made Mr. Bebchuk something of a prophet a few years ago, in 2004 to be exact, when he and Jesse Fried published a book titled "Pay Without Performance."

The book didn't treat extravagant executive pay so much as a moral issue or a sign that America had become vulgar in its rampant materialism. It treated it instead as an economically unsound practice that made executives rich but harmed the companies they led and contributed to the recent financial meltdown.

Now people are listening as Mr. Bebchuk has played an ever more prominent role in the national debate over how to fix a system that melted down last autumn and early this year, taking part in meetings with Treasury Secretary Timothy F. Geithner, writing position papers and pressing his point that, contrary to the continuing insistence of free-market true believers, the financial system wasn't obeying the dictates of the market; it was obeying the dictates of corporate bigwigs who wielded too much power, including over how much money they would be paid.

"The larger cultural question is big and important," Mr. Bebchuk said, referring to the morality of excessive pay. "But I've been focusing on a problem that would be a problem even if the other stuff wasn't a problem.

"There is a big debate about the growing inequality of wealth arising from market outcomes, and reasonable people can disagree on whether something should be done about it," Mr. Bebchuk continued. "My fundamental problem with executive pay, however, is that it's not produced by a well-functioning market and has created large distortions in how companies are managed."

In other words, paying hundreds of millions to the C.E.O.'s of banks and investment companies isn't bad in itself, but the way it's done has delinked pay from performance.

"The largest cost of executive pay arrangements was likely not the excess pay itself," Mr. Bebchuk said. "It's that perverse incentives have been produced that may have cost shareholders and society a lot more than what the executives were being paid."

There's a certain vindication in the ongoing financial crisis for Mr. Bebchuk and a small band of others who have for years bucked the free-market orthodoxy that itself goes back to Adam Smith, namely that pay was regulated in some way or another by the invisible hand of the market, and, by implication, that the stratospheric salaries and benefits of the boss were accurate and justifiable reflections of the value these exceptionally talented people created for the common welfare.

"There was this paradigm that executive compensation served the interests of shareholders," Mr. Bebchuk said, "but when we looked at the paradigm, we found that it had shaky foundations."

To be sure, you didn't over the past few years have to be a professional economist to sense that something was wrong with executive pay, and there have always been people striving to call attention to it. In the months leading up to the current financial crisis, the Democrats on the House Financial Services Committee, led by Representative Barney Frank of Massachusetts, put out a set of arguments that certainly sounded the alarm.

According to Mr. Frank, executive pay in 2004 was 431 times the pay of the average worker, and in the decade before 2005, executive pay increased five times faster than the pay of the ordinary employee of that company. The figures were, not surprisingly, even starker when C.E.O. compensation was compared to that of people trying to survive on the minimum wage.

"An average C.E.O.," the Democrats on the House committee wrote in a 2006 report, "makes more before lunch on his first day of work than a minimum wage earner will make all year."

The argument on the other side was that the market, which needed to be allowed to function, decreed that the C.E.O. produced more value in that single morning of work than the minimum wage worker did all year, and that's why efforts to curb the C.E.O.'s pay would harm the larger economy.

"Americans don't generally have a problem with the huge pay that athletes, movie stars, and other celebrities are making," Mr. Bebchuk said. "What's now producing the outcry over executive compensation is not the sheer numbers but the disconnect between pay and performance and the sense that executives have an undue influence on their own pay."

Mr. Bebchuk, who continued his "crusade" earlier this month when he testified before the House committee, argues that that pay and the long-term performance exist in an inverse relationship, wherein the methods used to reward C.E.O.'s produced incentives for those C.E.O.'s to stress the short-term gain at the expense of long-term rationality, especially the taking on of excessive risk.

"The ability to take a large amount of compensation based on short-term results," Mr. Bebchuk told the committee last week, "provides executives with powerful incentives to seek short-term gains even when they come at the expense of long-term value."

To Mr. Bebchuk, the solution isn't for the government to micromanage executive compensation. Rather shareholders, who are very weak in America compared with shareholders in other countries, should be given more power to replace directors and to change corporate bylaws.

For companies in the financial sector, the fundamental change advocated by Mr. Bebchuk and others is to regulate more but also to regulate the right things.

"The government should monitor and regulate banks' executive pay," he said. "The point is not to limit the amount of executive pay but to limit incentives to take excessive risks."