What if C.E.O. Pay Is Fair?

The New York Times
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October 13, 2007

“I really don’t want to answer that question,” said Ira T. Kay, flashing me some combination of half-grin and half-grimace. “I have clients.”

Does he ever. Mr. Kay, 57, heads the executive compensation practice at Watson Wyatt Worldwide, which is one of the country’s leading compensation consulting firms. He is a funny, gregarious man, quick with a clever retort, and utterly without guilt about what he does for a living — not only enabling big-time chief executives to make oodles of money, but defending most of the practices that allow corporate chieftains to reap their millions.

For years, Mr. Kay has overseen an annual Wyatt Watson executive compensation survey, which the firm describes as an effort to provide “perspective on the executive pay model in general, pay for performance, stock ownership and share usage.” The Ira Kay perspective, not surprisingly, is that while there may be a few problems here and there (about which more later), the model is a darn good one.

A few months ago, Mr. Kay wrote a book entitled “Myths and Realities of Executive Pay” (Cambridge University Press), with Steven Van Putten, a Watson Wyatt colleague, that goes even further. “It is not a coincidence that the Dow Jones industrial average, which stood at 5,000 in 1996, is now well above 13,000,” the authors write. “While U.S. executive pay practices do not entirely explain this rise, there is little doubt that it would not have occurred without them.” I’ve heard Mr. Kay make this point before — and even debated him on it. He really does seem to believe that all of the great economic benefits we’ve enjoyed in this country during the past two decades or so can be traced back, in no small part, to the way we pay our chief executives. I, on the other hand, believe he’s got the cause and effect exactly backward: that it was the rising market that made the lucky fellas running America’s corporations look like geniuses — and made them richer than they’d ever imagined, thanks to the shift to stock options as the primary way to reward executives.

When I went to see him this week to talk about his book, Mr. Kay made the point in a more specific, Gordon Gekko kind of way. “There is no question,” he told me, “that these programs motivate superior performance. They cause C.E.O.’s to make difficult decisions that are otherwise unpleasant. They sell off businesses. They move offshore. The desire for personal gain causes them to do the hard stuff.” In other words, greed is good.

But then I asked him the question that caught him up short. I wanted to know whether he believed that the many critics of executive compensation — all of us who think there is something fundamentally wrong with a system that allows the C.E.O. to make 400 times what the average worker makes — were practicing a form of class warfare? In other words, is there a moral element to the debate over C.E.O. pay? Those were the questions

the normally loquacious Mr. Kay didn't want to answer. They are also questions, I realized, that I've been avoiding as well.

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Here's a thought exercise. Suppose we lived in an ideal world, where the pay-for-performance system of executive compensation was a reality, instead of the mirage it is today. Suppose that boards of directors actually conducted tough arms-length negotiations with chief executives. And chief executives had deals that brought them mega-wealth only if the company's profits rose sharply and the stock price went up. And that if they failed to increase profits and the stock price, and got fired, they didn't get to line their pockets on their way out the door. If that were the case, would you still be outraged at the staggering sums chief executives make?

Interesting question, isn't it? Among institutional investors and in the media, the argument against multimillion-dollar C.E.O. pay packages is almost always phrased as a problem with the pay-for-performance model that Mr. Kay so stoutly defends. For instance, the furor that arose last year over the compensation of Robert L. Nardelli, the former chief executive of Home Depot, was not simply that he made an outrageous amount of money — but that Home Depot's stock price hadn't done a thing in the five years he'd run the company. His pay didn't justify his performance.

But it's hard to believe that those leading the charge against his pay package, starting with the American Federation of State, County and Municipal Employees, weren't upset mainly by the fact that Mr. Nardelli had a $200 million pay package in the first place — no matter how he had performed. Indeed, if you go to the Web site of many of the big unions — not to mention the many religious organizations that have taken to shareholder activism — you'll see manifestoes decrying the enormous C.E.O. pay packages that are par for the course today. Many of them are especially mournful of the growing gap between the pay of the chief executive and that of the average employees. When the big unions target underperforming C.E.O.'s each year, they are doing so mainly because it is the easiest way to generate outrage over the fact that all chief executives are paid so much.

I've long been a member of the "chief executives make too much" school. I think executive compensation is a socially corrosive issue, especially when the middle class is struggling. I think it creates morale problems when the C.E.O. makes so much more than even other top executives. But what offends me most is a somewhat different issue: that the market for executive compensation is so clearly rigged. Chief executives sit on one another's boards, so they have an incentive to take care of one another. Directors are predisposed to want to make the chief executive happy since, after all, he or she is the one who picked them for the board. Far too often, a chief executive's pay isn't a result of an arms-length negotiation, but a result of a kind of a corporate buddy system.

Mr. Kay, of course, insists that there is a real market for C.E.O. pay — rather than the rigged market I just described — though he does grant that "C.E.O.'s have relative power

compared to their boards." He can cite statistic after statistic, using such measures as "realizable long-term incentive pay," showing that high-performing chief executives put more money in their pockets than those whose companies do poorly.

But what struck me in speaking to him was the way in which he himself seemed to acknowledge that, at long last, the game itself was becoming at least a little less rigged. The constant clamor by institutional investors has had an effect on boards, he said. What's more, "boards are starting to play hardball on severance, pensions and perquisites." He added, "It is a strategic shift in the labor market, because these goodies used to come with the package."

Indeed, he told me he had begun recommending to boards that the severance packages for chief executives, which have been such a source of controversy, be pared back, especially for chief executives who have been on the job for a while and have reaped considerable compensation rewards. Two companies, he added, had agreed to do so — though he declined to identify them. (They're clients after all.) A few days after he spoke to me, Mr. Kay spoke at a conference run by Jesse M. Brill, one of the loudest executive compensation critics and publisher of CompensationStandards.com. When I spoke to Mr. Brill the day before the conference, he was practically beside himself with excitement — Mr. Kay, he told me, was going to publicly denounce outsize, and unnecessary, severance packages. "It's a very big deal," he said.

And it could be — if it leads other compensation consultants to follow his lead, and boards to begin rethinking big severance packages for C.E.O.'s who have either failed to perform or have been in the job so long they have already reaped tremendous rewards. But it's also just a start. What we really need is confidence that boards are finally treating the shareholders' money as if it were their own — and negotiating as fiercely as, say, Theo Epstein of the Boston Red Sox negotiates with Scott Boras, the famous player's agent. Which leads to one last thought exercise. Baseball players also make outsize salaries, as do actors and rock stars. You could easily make the argument that their pay is also socially corrosive — part of the growing gap between rich and poor — and even unfair given how little teachers make by comparison. But even many of the same people who think C.E.O.'s are paid too much don't take the same position about these other highly paid professions.

Why not? The reason, I'm convinced, is that we feel confident that they are being paid what the market says they're worth. Their compensation has been set by a real market, not a rigged one. And markets, in the end, aren't moral or immoral. They just are. We accept their judgment.

I asked Lucian Bebchuk, the big compensation critic at Harvard, what would happen if C.E.O. pay was finally subjected to real market forces. My worry is that it has risen so high in the rigged market that it would never come down, even in a real one. Professor Bebchuk disagreed. "We cannot predict the true market level because we have not had a well functioning market," he said. "But markets do adjust. If the true market level were

significantly below the current level, then compensation would go down. It wouldn’t happen overnight, but it would happen.”

And if it didn’t come down? If it turned out that in a real market for C.E.O. pay, their compensation remained in the stratosphere? I might not like it, but I could live with it.

Could you?