Overcompensating

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Markets thrive on information. The more investors know about a company, the more likely they are to figure out what that company is really worth. So when the Securities and Exchange Commission recently proposed a new set of rules requiring companies to disclose more information about exactly how much (and in exactly what ways) they pay their top executives, it seemed like a market-friendly no-brainer. Corporations are already required to issue statements detailing C.E.O. pay packages, but they often bury important data in footnotes or beneath mounds of obfuscatory language, so that even sophisticated investors find it hard to get a clear picture of how much C.E.O.s earn. The S.E.C.'s proposed rules will require companies to disclose more about executives' perks and stock-option grants and about their future pension benefits. Companies will also have to provide a single figure summarizing all the money an executive is scheduled to get. They can still pay their bosses as lavishly as they like. They'll just have to tell investors what they're doing.

The new rules seem sensible and inoffensive, but they've already come under fire. Some critics complained that the S.E.C. had no business meddling with internal corporate decisions, and that the cost of the regulations far outweighs any possible benefit. But the critics' real beef is that they think the rules are driven by politics, not economics. As Fred Smith, Jr., the head of the Competitive Enterprise Institute, put it, "This is playing to the simple egalitarian concern that a world where everybody gets paid the same amount would be a better world." Only crypto-Marxists and softhearted liberals, in other words, worry about how much C.E.O.s make. There's certainly plenty of populist concern about C.E.O. pay, perhaps because the average big-company C.E.O. now makes more than three hundred times what the average worker makes. But the S.E.C.'s commissioners (three of whom are conservative Republicans) came up with the new rules not because workers care about how much C.E.O.s make but because shareholders do. Big institutional investors and major value investors like Warren Buffett now pay far more attention to executive compensation than they once did. And when they speak the S.E.C. tends to listen.

In part, executive compensation matters to investors because executives now take so much money out of corporations every year. According to the economists Lucian Bebchuk and Yaniv Grinstein, between 1993 and 2003 the top five executives at fifteen hundred companies in the U.S. were paid three hundred and fifty billion dollars. That level of pay makes sense only if it leads to better performance. But plenty of executives are getting superstar pay for journeyman work. For one thing, executives are rewarded far more for good luck in their industry (like rising oil prices that they had no control over) than they are punished for bad luck, according to a study by the professors Gerald Garvey and Todd Milbourn. Though most of their pay is now in the form of stock or stock options, C.E.O.s' cash salaries have also risen sharply over the past decade; in 2005, the average C.E.O. got paid millions literally just for showing up. And lavish perks—ranging from personal use of the corporate jet to having the company cover the C.E.O.'s income taxes—remain ubiquitous.

More important, it's becoming increasingly clear that, from a shareholder's perspective, overpaid C.E.O.s aren't just expensive; they're downright destructive. One recent study of the market between 1992 and 2001 by economists at Rutgers and Penn State found that the more a C.E.O. was paid, relative to his peers, the more likely his company was to underperform in the stock market. The economist David Yermack, of N.Y.U., has found that companies that allow their C.E.O.s to use corporate jets for personal reasons fall short of market benchmarks by four per cent annually. There are myriad ways in which excessive or poorly designed pay packages can do damage. "Golden parachutes," which guarantee executives huge payoffs if their companies are acquired, may encourage them to sell out even when the company would be better off remaining independent. Conversely, according to a study by the finance professors Jarrad Harford and Kai Li, very highly paid executives are more likely than their peers to make acquisitions, and to receive major financial rewards for doing so, even when the acquisition ends up destroying corporate value. And there is evidence that overpaid C.E.O.s are more likely to commit fraud that props up stock prices—perhaps because the more you have to gain from criminal activity, the more likely you are to engage in it.

This doesn't mean that all lucrative pay packages are a waste of money. But, more and more, big investors are treating excess compensation as a reliable index that something serious may be wrong. In particular, it's often a sign that a company's board of directors is catering to the C.E.O.'s whims rather than supervising him. While the S.E.C.'s new rules won't solve the problem of weak boards or overweening C.E.O.s, they will make it easier for investors to figure out exactly who is being paid what, and to make an informed decision about whether to buy or sell a stock. We shouldn't expect to see a dent in executive compensation anytime soon. But in the long run companies that don't balance pay with performance tend to suffer where it matters most—in the stock market.