Shameless Gougers

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Nothing disgraces American capitalism so much as the enormous, and growing, disparity between the pay and performance of many top executives. With remorseless efficiency -- and for the greater good of the country, as I usually try to argue -- American free enterprise grinds away at almost every kind of cost, and notably the cost of labor. This process, brutal as it may seem, drives growth in productivity, in national income, and ultimately in living standards. It is the foundation, and the price, of America's economic success. That is what many a chief executive will tell you, as well, with all due gravity. But in so many cases, this zeal for control of costs is jarringly absent when it comes to those bosses' own pay. Many CEOs are gouging the owners of the companies they work for, and they are doing it shamelessly. Shareholders, unfortunately, keep letting them get away with it.

Every proxy season brings new evidence of amazing rapacity. In the past few days, The *Wall Street Journal*, The *New York Times*, *USA Today*, and other papers have run long and admirably detailed reports on the subject, drawing on the latest company filings. The theme of the coverage is not new by any means, nor are the particular instances in qualitative terms. In fact, people are getting inured to the issue, and that is only going to make things worse. Steadfast critics of capitalism express the usual outrage over these cases, of course, but that carries no weight: They are routinely outraged about so many things. It is the embarrassed silence of the defenders of capitalism that is so disappointing, and that really matters. Those people should be ashamed, and seen to be ashamed, of the injustice -- of the brazen ethical failure -- that lies behind each new crop of figures.

The *New York Times*, with good reason, paid particular attention to the case of Verizon. The firm's CEO, **Ivan G. Seidenberg**, received $19.4 million last year, in a mixture of salary, bonus, restricted stock, and other payments, a rise of nearly 50 percent over the previous year. That was justified, according to the company's compensation committee, because Seidenberg met some "challenging" performance benchmarks. So the company did well in 2005? Not exactly. Earnings fell by 5.5 percent, the company's shares dropped 26 percent, and its bonds were downgraded. The *Times* also reported that 50,000 of the firm's managers had their pensions frozen. (The company had a difficult year, you see: The pension freeze was doubtless a painful but necessary sacrifice.)

Verizon is on a list of 11 big companies accused of "paying for failure" by The Corporate Library, a corporate-governance research outfit. In a just-published study, TCL found that over the past five years board compensation committees "authorized a total of $865 million in pay to CEOs who presided over an aggregate loss of $640 billion in shareholder value." The 11 companies are AT&T, BellSouth, Hewlett-Packard, Home Depot, Lucent Technologies, Merck, Pfizer, Safeway, Time Warner, Verizon, and Wal-Mart. Each of these "paid their CEOs more than $15 million in the last two available fiscal years; had a negative return to stockholders over the last five years; and underperformed their peers over the same period."

But the problem goes much wider than this. Year in, year out, the median pay of top executives rises much faster than do overall wages and salaries. There is no reason why this should be so -- not if the market for CEOs is working as rigorously as the market for other kinds of labor. But, of course, it is not. There is no economic rationale, no "incentivizing" justification, for enormous severance payments to departing (failed) CEOs, or for full-salary pensions worth eight figures or more, granted to bosses about to retire. The idea is a joke. The cases that TCL has drawn attention to, and the wider trend of rising CEO pay regardless of performance, show that the market for CEOs is broken.

That is a bad thing in itself -- and, fairness aside, the scale of the resulting misallocation of resources is not small. An academic study published last year by **Lucian Bebchuk** and **Yaniv Grinstein** in the *Oxford Review of Economic Policy* estimated that from 2001 to 2003, the total pay of the five highest-earning CEOs of public companies was equivalent to nearly 10 percent of the companies' earnings, roughly double the share of earnings paid out that way from 1993 to 1995. Pay on that scale, if it elicits no improvement in company performance, is perceptibly depressing return on investment. That, as I say, is serious enough, but a far larger cost comes in damage to the system's reputation.

Most CEOs understand, or say they understand, that capitalism needs the tacit support of the public to function well. In fact, to judge by much popular culture, Americans are already fairly distrustful of capitalism -- but these things are relative. If Americans were as hostile to big business as, say, the French are, then the tax and regulatory regime for American companies would quickly evolve to become as unfriendly and dysfunctional as France's. When compensation committees vote huge and patently unwarranted pay increases for their nonperforming CEOs, they are working to that end. They are not just failing in their duty to the shareholders whose interests they are paid to uphold, they are hurting the rest of us as well. They are undermining capitalism more surely than its avowed opponents and making its defenders look like spokesmen for base hypocrisy.

Can anything be done about it? For most corporate-governance activists, the remedy of first resort is greater disclosure. The Securities and Exchange Commission has a proposal that will oblige companies to give more information about the total pay of their top executives, making it easier to do a full accounting. This should go further.

In the face of opposition from business leaders, regulators are not pressing for disclosure of the performance formulas (if any) that compensation committees apply in designing CEOs' supposedly performance-related packages. That is a mistake. TCL's research points to cases where compensation committees authorize bonuses that start to pay out if the company stands at well below the median of the chosen measure of success. In other words, even if the company is doing worse than most of the firms in its segment, its CEO can expect to collect a bonus for good performance. Very challenging. Perhaps, if companies had to report schemes as ludicrous as this to shareholders and had to document them in detail, more compensation committees would hesitate to approve them.

The *Times* drew attention to another anomaly, reminiscent of the conflicts of interest that have plagued auditors and investment analysts. Many compensation committees use outside advisers to guide them and to sanctify the pay schemes they decide upon. But these advisers apparently do lots of other business -- worth far more to them than the advice on CEO pay -- with the firms concerned. They may design or manage the firm's employee-benefits system, for example. So they are giving advice on how much to pay the CEO at the same time that he or she is deciding how much other business to send their way. At the moment, companies do not have to disclose these relationships.

But one may ask whether greater openness will be enough. Some businesses argue that disclosure will make matters worse -- that easier comparisons of CEO pay will ramp up the money even more. It is an insincere argument, of course -- "Please don't push my pay up even faster" -- but it might actually be true, especially since many compensation committees appear to set pay, or elements of pay, at a percentile of CEO compensation across their industry. What an abject abdication of responsibility to shareholders that is. Moreover, if every CEO expects to be paid at least as well as the average, you have a never-ending upward spiral of cost -- and fuller disclosure might then indeed make matters worse.

The answer lies in the combination of greater disclosure and greater power for shareholders. We need both, so that the owners can do something with the information. In short, CEOs need to be made less secure. Regulatory and legal restraints on hostile takeovers -- much the best discipline on boards that forget their fiduciary responsibilities -- need to be rolled back. Also, public companies should be obliged to put the fully disclosed pay of their top executives to an annual shareholder vote (as in Britain), and (unlike in Britain) that vote should be binding on the company.

Even then, shareholders would have to be willing to exert themselves -- something that, in America, they have often been oddly reluctant to do. They lose a lot by their passivity, and so, unfortunately, do the rest of us.

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