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When the Blind See Better

The combined compensation for the heads of America's 500 biggest companies increased by 54% in 2004. Harvard professor Lucian Bebchuk's calculations show that the top five executives now collect 10% of the average big firm's net income, double the percentage a decade ago. This is a problem that affects not just morale but competitiveness.

It's devilishly difficult to figure out how much bosses should be paid. Pay too little and your company will not attract quality leadership. Pay too much and you shrink the bottom line.

We don't want Stalinist central planning. But this is an area where the invisible hand of the market works poorly. Executive compensation is determined by a compensation committee of the board. In practice, the committee subcontracts the work to a compensation consultant. Consultants only make matters worse. Although they are supposed to be independent, the reality is that they are more likely to be rehired when the chief executive is happy with the result. Every firm likes to think its boss, like the children of Lake Wobegon, is above average. Thus the compensation consultant is more likely than not to find that the client has an above-average performer in the corner office.

The problem is that when most firms pay an above-average wage, the average skyrockets. Even in a world where half of the firms think that the chairman deserves just the average but the other half pays more than the average, then average pay will explode. If this year's numbers are between $1 million and $3 million, and next year everyone gets at least the average, then the bottom half will all jump to $2 million, a 33% increase for the worst performers.

There is a solution to this mess. To increase the objectivity of compensation consultants, we should give them less information. The consultants should be hired blind. They would be independent because they wouldn't know which side of their bread was buttered.

The compensation committee would arrange for a law firm to hire the consultant without disclosing the client. The consultant would be given a list of ten firms in the industry. The consultant would be asked to rank the executives' performance and suggest salaries for each. Half the chief executives would be ranked in the bottom half and presumably would be paid accordingly.

Indeed, the Securities & Exchange Commission could mandate that compensation studies be made public. Shareholders might like to know if the other consultants consistently rank their chief executive below average.

Not that it would be any cause for alarm if half of publicly traded firms discovered that their chief executive officer falls in the bottom half. Remember the old joke about what they call the person who graduates at the bottom of the class at Harvard Medical School? The answer is "doctor."

Consultants will complain that they can't do their job without insider access to a firm. But that's a problem that biases the current system because they only get insider access to the client. Maybe the comparable bosses also look better the closer you look.

We know that blind evaluations work from our own experience. The late economist James Tobin convinced Yale to adopt this approach for evaluating professors. When Yale wants to hire a senior professor from a different university, we ask outside reviewers to rank a list of ten famous professors in the field. It may well be the case that some of the names are not interested in the job. But the reviewers don't know who is a live candidate and who isn't. It's hard to play favorites when the reviewer doesn't know who you are looking at.

We also grade exam papers with code numbers replacing students' names. Nowadays orchestra auditions take place with the player behind a screen. Blind auditions have miraculously increased the probability that women will be hired. Since the introduction of screened auditions in the early Eighties, the percentage of female players has increased fivefold in the top U.S. orchestras.

Just maybe, screened evaluations of chief executive officers could spur an analogous revolution in executive pay.

Labor economists Claudia Golden and Cecilia Rouse at Harvard and Princeton, respectively, have studied the effect of blind auditions on orchestras; their paper can be found by Googling "blind auditions." You can get a FORBES scorecard on executive pay versus performance by going to Forbes.com/lists and clicking on Top-Earning CEOs.

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