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"Summary of article by Derek Bok: The Cost of Talent: Summing Up"

The top salaries in management and in some professions have risen extremely rapidly since the 1970s, far exceeding the growth rates of most wages and salaries, or of the output of goods and services. This chapter, summarizing a book-length analysis of the escalating standards for managerial and professional compensation, addresses three questions:

> Are certain executives and professionals significantly overpaid? Is the supply of intellectually gifted university graduates distributed among the fields in a manner that matches the nation's needs? Do current methods of compensation motivate professionals to work suitably hard for appropriate goals? (223)

Are Some Professionals Overpaid?

It is hard to avoid the impression that top-level salaries are excessive when, for example, the CEOs of General Motors and Ford earn three or four times as much as their counterparts at Honda or Toyota, or when the partners at some large law firms have average individual earnings greater than the combined salaries of all nine Supreme Court justices. In fact, the incomes of medical specialists and the profits per partner at elite law firms have risen sharply since 1970, despite the unusually rapid growth in the number of doctors and lawyers. CEOs of large firms have likewise had soaring incomes at a time when the number of MBAs has jumped upward, and when foreign firms have challenged American business more successfully than in the past.

Top executives, doctors, and lawyers have fared so well because they sell their services in labor markets with several unique characteristics. The work that they perform is important and differentiated enough that there is a great incentive to pick the best available candidate – but it is extremely difficult to make such choices well. Seldom are there clear measures of a candidate's past performance; nor do those making the hiring decisions know the identity, let alone the qualifications, of all potential candidates. Under these circumstances it is easy to choose the candidate with the greatest reputation, a process which of course reinforces existing inequalities of reputation and incomes. Price competition is rare; someone who offered to work for less than the going rate might appear to be of lower quality, repelling rather than attracting clients.

Moreover, leading professionals and managers can often keep some control over the level of their earnings. Few clients or patients can judge exactly what they need from their lawyers or doctors. CEOs control the information received by boards of directors that evaluate them; often CEOs even pick the consultants or committee members who recommend executive pay

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increases. Under these uncompetitive market conditions, publicizing high salaries for CEOs, or high profits per partner at law firms, may have the perverse effect of encouraging others to demand more in an effort to catch up or stay ahead.

Do high salaries matter? Several reasons have been suggested for minimizing the problem, including: the high degree of mobility in and out of the top income groups; the relatively small amounts of money, in aggregate terms, earned by those at the top; the innovative investments and charitable contributions made by the rich; and even the claim that money matters little because it cannot buy happiness. None of these arguments are persuasive. There is limited mobility in and out of top income brackets, especially for the managers and professionals under discussion here; the rapid growth of top incomes has made their aggregate importance greater than it used to be; charitable contributions, even by the very rich, are less than 3 percent of income on average; and survey data suggests that richer people are, in fact, slightly happier than others. Finally, extreme inequality might be morally objectionable on grounds of fairness, regardless of the relationship between income and happiness.

How Well Is Talent Distributed?

Do distortions in the system of executive and professional pay lead to distortions in the allocation of talent to different occupations? Lured in part by hopes of high earnings, students apply to law schools, medical schools, and business schools in much larger numbers than the system can absorb. Similarly, international comparisons suggest that America has many more executives and lawyers per capita than other industrial nations, and is near the high end of the range in doctors per capita.

The best students, by any of several measures of academic ability and success, are disproportionately likely to go into medicine, law, or business. They are correspondingly less likely than other students to go into school teaching or other public sector careers; those who do enter such careers often leave after just a few years. Yet it is clear that our society needs an abler, better-educated corps of teachers and public servants than we have had in the recent past.

Even within the best-paid professions, the differential pattern of salaries may lead to misallocation of talent. Large proportions of the best new entrants are attracted to high-tech specialties within medicine, corporate law firms within the legal profession, and careers in finance within the business world. In the early 1970s, graduates from leading law and business schools earned about the same starting salaries in the federal government or on Wall Street, and made about twice as much as a beginning teacher. By 1990, Wall Street salaries were double the starting pay in the federal government and four times the salary of a beginning teacher.

> These large and growing differences are considerably greater than those in most other industrialized countries. They have undoubtedly helped to cause the shift of talented young people from the public to the private sector. There is little reason to suppose that the country will be better off as a result. (242)

How Successful Is Merit Pay?

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Many organizations made renewed efforts in the 1970s and 1980s to tie compensation to performance. Merit pay was introduced for teachers and civil servants; boards of directors gave CEOs lucrative incentive pay packages to spur greater efforts; law firms began to pay partners on the basis of current accomplishment rather than seniority; HMOs began to experiment with incentive plans for salaried doctors.

"The striking fact about these attempts is that they have all either failed completely or fallen far short of expectations." (243) Bonus systems in the federal government have been poorly administered, or too small to matter. CEOs have manipulated incentive pay schemes so that the link between their compensation and performance is embarrassingly weak. Appropriate incentives for doctors are notoriously difficult to design; simple systems often reward doing too much (when doctors are paid for working harder) or too little (when there are bonuses for cost-consciousness).

All pay-for-performance schemes assume that monetary rewards will motivate people to work harder and more effectively. Although seemingly obvious, this premise is supported by surprisingly little empirical evidence. Financial incentives do seem to have a positive effect on the performance of routine, repetitive tasks, but this effect does not necessarily translate to the more complex, creative jobs expected of managers and professionals. We know very little about the incentive effect on a multimillionaire CEO of a chance to earn another million dollars. Nor do we know how a bonus affects professionals in fields such as teaching or public service, careers which have often been chosen for reasons other than making money.

Even if performance pay were an effective motivator, it would be difficult to implement such methods of compensation. The requirements for an effective incentive pay system are formidable, including: clear, objective procedures for definition, measurement, and evaluation of performance; honest and impartial communication of the results of performance assessments; widespread understanding of the goals of the system; goals high enough to be challenging but not so high as to be frustrating; rewards large enough to provide real motivation, but not so large as to encourage cheating; and recognition of all the behaviors and objectives that are to be encouraged, and design of a balanced package of incentives that rewards them in the right proportions.

It is hardly surprising that one or more of these vital elements are often missing, rendering incentive systems ineffective. A failed performance pay plan can leave an organization in worse shape than before, by fostering rivalry among co-workers, disrupting harmonious working relationships, and increasing the focus on making more money instead of doing the best possible job. The lavish paychecks so often given to CEOs of poorly performing companies symbolize the failure of twenty years of attempts to use financial incentives to improve performance.

In conclusion, it is clear that the competitive market that regulates executive and professional compensation has many imperfections. Those who employ professionals, and those who establish their compensation, are often poorly informed. In the private sector, executives and professionals exert great influence over their own compensation because of their knowledge and power within the organizations that employ them. No "unseen land" guides the realtive levels of

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compensation in the public and private sectors to ensure an adequate flow of talent into such occupations as teaching or government services.

> Under such artificial conditions, there is no reason to suppose that the process of fixing professional compensation will result in just rates of pay, or produce an optimal distribution of talent, or create a system of incentives calculated to elicit the kind of effort needed to excel in the important tasks that professionals perform in our society. (247)

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