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What's Wrong with Executive Compensation?

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ABSTRACT. I broadly explore the question by examining several common criticisms of CEO pay through both philosophical and empirical lenses. While some criticisms appear to be unfounded, the analysis shows not only that current compensation practices are problematic both from the standpoint of distributive justice and fairness, but also that incentive pay ultimately exacerbates the very agency problem it is purported to solve.

KEY WORDS: executive compensation, distributive justice, pay disparity, incentive alignment

Introduction

Few academic theories have been adopted as widely as the application of agency theory (Jensen and Meckling, 1976) to the structure of executive pay in modern corporations. After prominent suggestions that the inherent conflict of interest that exists between stockholders and corporate managers – or 'agency problem' – could be mitigated through the structure of managerial incentives (e.g., Jensen and Murphy, 1990a), the prevalence and size of stock option grants to senior executives have expanded increasingly and substantially (Hall and Murphy, 2003; Rynes and Gerhart, 2000). Measured solely by its implementation into business practice – for good or ill – agency theory is a scholarly success story (Garen, 1994; Mengistae and Xu, 2004).

An increasing number of critics, however, have expressed dismay over the current state of executive pay. Certainly there is a widely held view in the court of public opinion that CEO pay packages are grossly exorbitant (Elkind, 2004; Farkas et al., 2004), and some critics decry the increasing earnings gap between the executive suite and 'average' corporate workers (Dash, 2006; Miller, 2006; Swanson and Orlitzky, 2006). A primary theoretical critique, on the other hand, is that an agency-based view of compensation generally embodies a completely undersocialized view of organizations, viewing participants as self-interested, atomistic, and largely uninfluenced by social relations. According to such sociological critiques, such an underspecified view of organizational action ignores the ongoing social structures within which managerial action is embedded (Granovetter, 1985), mistakenly disregarding the influence of anything other than economic incentives and information asymmetries on organizational behavior (Lubatkin, 2005).

In addition, other critics take specific aim at the *efficacy* of incentive alignment as a solution to the agency problem, levying a slightly more pragmatic critique: it simply does not produce the desired results. Observers ranging from journalists (Morgenson, 2002) to business consultants (Crystal, 1992) to scholars (Bebchuk and Fried, 2003) suggest that the increased use of stock option compensation may in fact create more incentive alignment problems than it solves.

So what does all this mean? Given that previous examinations of the ethics of executive compensation have proven inconclusive (e.g., Nichols and

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Subramaniam, 2001), what, exactly, is the problem with executive pay? Are CEO pay packages simply too grossly large on some absolute scale, driven by unfettered greed beyond the bounds of what is ethically reasonable? Or is the real problem the growing disparity between executive pay and the wages of entry-level workers? Alternatively, is there a problem with CEO pay from the standpoint of distributive justice, or fairness? Or is the problem simply that executive compensation does not work properly – that it does not provide the proper incentive alignment suggested by the underlying theory? I broadly explore these questions by examining several common criticisms of CEO pay through both philosophical and empirical lenses, and conclude with implications for theory and practice.

Objection #1: CEO pay is unreasonable on its face, based on its gross magnitude

Much of the criticism levied against high levels of executive pay simply contends that it represents self-dealing of a magnitude that has crossed the threshold of what is morally defensible. For instance, a study several years ago focus groups comprised of 'ordinary Americans' expressed outrage over burgeoning CEO pay, especially during times of employee cutbacks – citing greed as the primary source of their objection (Farkas et al., 2004). Consider the well-publicized case of Richard Grasso, who, in the context of a decade fraught with corporate scandals involving cooking the books, market manipulations, and other illicit behavior on the part of executives, was forced out as chief executive of the New York Stock Exchange simply because he was paid too much (The Economist, 2003). A recent Los Angeles Times/Bloomberg survey (Benjamin, 2007) found that 80% of Americans consider CEOs to be overpaid. Certainly these findings would resonate with economist John Kenneth Galbraith, who purportedly said that the compensation of the chief executive of a large corporation is not so much a market award for achievement as "a warm personal gesture by the individual to himself." Unfettered greed, in other words, is often implicated as the problem with executive pay that so many find objectionable.

While this most basic objection to high executive pay receives a fair amount of coverage in the media, and may appeal to the moral sentiments of those of us who learned at our mother's knee that vices such as greed are improper, the objection in reality has very little traction. First of all, what is greed? And when does it become objectionable? If a highly paid CEO is considered greedy simply based on the absolute magnitude of his or her total pay, at what magnitude does such pay become *un*objectionable? What is the standard level of compensation that is morally acceptable? What absolute yardstick is to be used? These are intractable questions without systematic, rigorous answers. Is $30 million too much? How about $500,000? The answer depends largely on one's personal sentiments that derive mainly from one's own frame of reference, and so the challenge in answering such questions is that ultimately an objection to the *absolute* magnitude of CEO pay either reveals itself to be self-referential (in which case objecting to the CEO's greedy pay package is indistinguishable from one's envy of it) or it collapses altogether into a slightly more sophisticated objection.

Objection #2: CEO pay is unreasonable on its face, based on its *comparative* magnitude

One such objection is the argument that the gap between CEO and worker pay has grown too large. That the disparity between CEO pay and the pay of rank-and-file workers has increased is beyond dispute; total compensation for executives in the United States has steadily risen over the past several decades, whereas the earning power of ordinary workers has lagged (Mishel et al., 2007).[1] Data indicate that in approximately 10 years, CEO pay jumped from 100 times the pay of a typical worker in 1990 to somewhere between 350 and 570 times the pay of a typical worker, primarily through the use of stock options (Hall and Murphy, 2003; Rynes and Gerhart, 2000). This means, for example, that a ratio of CEO pay to 'average worker' pay is 300:1, when mapped onto actual compensation data from 2003, translates to the average worker taking home $517 a week, with the average CEO earning $155,769 a week (United for a Fair Economy, 2004). On its face, this kind of data may seem objectionable to those with egalitarian leanings; a preference for such disparity on

the part of executives has been characterized as an indication of their ''normative myopia'' (Swanson and Orlitzky, 2006).

As with the first objection, however, it is difficult to articulate why a certain ratio of CEO to worker pay is *de facto* objectionable. Even if we acknowledge that income disparity is one of the vexing social problems of the day, framing the problem in terms of CEO to average worker pay ratios is an exercise in futility, for several reasons. First, although such comparisons can be (and are) often used to make headline-grabbing political points, there's something disingenuous about making such comparisons. Do we similarly compare the salaries of software programmers to those of taxi drivers? Attorneys to postal workers? Physicians to flight attendants? Business school professors to the custodians in their buildings? Would we ever go so far as to suggest that the pay scales of any of these occupations should somehow be calculated or constrained as a multiple of another? Of course not – not if we are serious about capitalism. A fundamental tenet of the market economy we participate in is the notion that different jobs with different educational requirements and differing levels of expertise and responsibility should probably be compensated differentially. It is entirely possible, of course, that the pay scale of a certain occupation or position is *inordinately* differential, which is presumably the implicit objection made when comparing CEO and average-worker salaries, but a ratio of one position's pay versus another's tells us nothing substantive about whether or not the grander pay package is exorbitant.

Second, when making such comparisons, what do we mean by executive and what do we mean by average worker? Even if we somehow accepted as meaningful the idea of comparing one job to another (with 'appropriate pay' for each being some function of the other), it is unclear in most cases what is actually being compared. Part of the challenge, then, is simply comparing apples to apples. Often the data on compensation reflects CEO pay at the largest corporations (e.g., NYSE-listed Fortune 500 or Fortune 250), and given that the size and complexity of managerial responsibility can be a big driver of compensation (Henderson and Fredrickson, 1996), this sample hardly constitutes a representative sample of CEO pay for all 10,000 public companies, big and small, much less than that of the many more privately held companies that make up the balance of the economy. It might make more sense to either compare top-management pay from a broader, more representative sample of firms, or (alternatively) draw the comparative employee pool from the same restrictive sample of large public firms in which executive pay is typically gathered. Furthermore, given the 'tournament' nature of corporate advancement (Conyon et al., 2001; Henderson and Fredrickson, 2001; Lazear and Rosen, 1981) – which suggests that CEOs attain their positions via prior outstanding performances as employees – the referent pool of 'average workers' should probably be further limited to those employees at the same firms who show the most promise and reflect a resume similar to the comparison CEOs in terms of educational background and other qualifying criteria. In other words, while I have argued that it is never clear why the pay grade of a CEO should be a function of average-worker pay in the first place, it is even *less* clear why executive pay would have anything at *all* to do with, say, the pay of a minimally compensated employee who is about to be fired for poor performance.

Third, if the appropriate comparison is of CEOs to all other types of workers, shouldn't the average-worker pool include the CFO, vice presidents, general counsel, and highly compensated knowledge workers at the firm, in addition to entry-level workers and minimum-wage employees? If this were done, the pay differential reflected by the ratio of CEO to average-worker pay would likely appear much less dramatic than often represented.

Finally, even if these concerns could be addressed by employing more systematic data that has comparative parity, the resulting ratio would still need to be interpreted, since one's own frame of reference will significantly influence how one views inequity (Lowery et al., 2008). In the case of comparing compensation, we would need to determine whether a compensat-ion gap is evidence of the highly paid worker being *advantaged*, or of the less-paid worker as being *disadvantaged*, the implications of which dramatically differ. Hence even if we were to somehow systematically establish that the pay scales of executives and average workers were inordinately disparate, we would *still* have to determine whether the real problem is the advantaging of one (e.g., CEOs are overpaid) or the disadvantaging of the

other (e.g., clerical workers are underpaid). The mathematical ratio comparing the two, on its face, cannot answer that question. In the absence of systematically addressing all these concerns, ratios of CEO to average-worker pay are meaningless.

Objection #3: high CEO pay violates principles of justice and fairness

Objections to high levels of executive pay that invoke considerations of fairness or distributive justice, while rarely articulated as such in the public sphere, potentially have more validity. People care deeply about fairness, despite deeply ingrained neoclassical theories of rational self-interest that claim otherwise. Consider the classic ultimatum-game experiment in which pair of subjects collectively decide how to divide a sum of money. One participant, the proposer, puts forward a suggested allocation of the money, and the second participant can either accept the offer, in which case the money is divided accordingly, or reject the offer, in which case both participants get zero. Although rational-expectations theory would suggest that any distribution – however small – is better than zero, the empirical results indicate that few participants propose or accept inequitable distributions (e.g., Guth et al., 1982). Indeed, fairness of distribution is so important that evidence from modified iterations of the ultimatum game show that participants are actually willing to *pay* to punish those perceived as acting unfairly (e.g., Kahneman et al., 1986). This experimental data has real-world implications; when lower-level managers perceive that they are underpaid relative to the CEO, they are more likely to leave the organization, illustrating that fairness consideration and their consequences are of key importance when setting executive pay (Wade et al., 2006).

Merely demonstrating empirically that people care about fairness, however, does not necessarily validate objections based on fairness. After all, as previously discussed, many people certainly believe that CEO pay is objectionable based on its absolute or comparative magnitude, yet I have argued against these objections. Can does not imply ought.

What, then, do normative theories of distributive justice and fairness tell us about executive pay? Rather than focusing on one particular theory, I briefly highlight insights from three fundamental theories of distributive justice: John Rawls's theory of justice as fairness (1971), the capabilities-based approach of Martha Nussbaum (2000) and Amartya Sen (1999), and the libertarian theory of Robert Nozick (1974). While each raises a variety of different objections when applied to executive pay, I focus here on their common objection to the *process* of selecting CEOs and determining their compensation.[2]

Rawls's second principle of justice articulates the notion of 'open position', or fair equality of opportunity. Because Rawls himself stipulates that this principle has priority over the other imperatives his theory includes (such as the 'difference principle'), satisfying the demands of fair equality of opportunity is the most important consideration from a Rawlsian perspective. In applying this standard to questions of executive compensation, we should consider how CEO pay is determined, and whether or not the CEO position itself is truly accessible to all.[3]

There are certainly troubling indications that CEO selection and pay determination are far from open, arm's length processes. For instance, an executive's pay is positively influenced by that executive's celebrity or notoriety (Hayward et al., 2004; Porac et al., 1999; Rosen, 1981) and by 'bandwagoning' or the use of popular management techniques on the part of the executive (Staw and Epstein, 2000). Davis et al. (2003) show that the largest firms in corporate America are overseen by a relatively small network of executives, with ties that have a substantial impact on issues of corporate governance, including executive pay (Hallock, 1997). Compensation committee members with close relationships to CEOs have been shown to be typically more liberal in awarding compensation than those members with more distant relationships (Young and Buchholtz, 2002), suggesting the presence of strong norms of reciprocity within the boardroom. In addition to such insiders, the executives themselves routinely sit on their own compensation committees, essentially facilitating pay packages for themselves of ever-increasing generosity. Given that Rawls's primary demand is for fair equality of opportunity, I suggest Rawls might say that such evidences are clear indications that the demands of fairness have been frustrated.

Although Amartya Sen and Martha Nussbaum approach questions of distributive justice somewhat

differently from Rawls,[4] centering primarily on human capabilities and freedoms,[5] they similarly reject opaque hiring and compensation practices that hinge on social connections, in favor of an open process predicated on merit and ability. Similar to the Rawlsian standard of fair equality of opportunity, the capabilities framework for distributive justice requires that individuals have "the right to seek employment on an equal basis with others" (Nussbaum, 2000, p. 80). In other words, if high levels of executive pay are an indicator that the CEO selection and compensation reflect exclusivity, favoring the advancement of cronies while limiting the opportunity for other qualified candidates to seek executive positions, then justice will have been compromised.

Central to their perspective is the notion that economic wealth is important only to the extent that it enables capability enhancement and, in that sense, is essentially a means to an end. There is no argument within the capability approach for income transfer solely for the purpose of wealth accumulation or distribution *per se*; in fact, there are clear examples of a disconnect between the two, wherein wealth transfer alone is not able to sufficiently mitigate a capability deprivation. Sen's (1999, p. 28) example of well-cared-for slave laborers who chose freedom over income, for example, highlights that human capabilities are much more important than money, and that one does not always lead to the other. Therefore, a capabilities-based analysis of high executive pay objects primarily to what it might represent: a closed process of filling the executive positions in the first place. In order to satisfy the demands of the capabilities approach, such positions should be open to all, providing each potential candidate for an executive position – as with all candidates for other, nonexecutive positions – an "equal starting place" from which to prove their merits for the position (Werhane and Radin, 2004, p. 171).

On the other hand, in his theory of distributive justice, Robert Nozick (1974) focuses primarily on liberty with respect to property, for the most part ignoring other capabilities and considerations. Nozick argues, essentially, that nothing beyond a so-called minimalist state – one that protects its members from force or fraud – is justified. But the foundational assumptions of Nozick's libertarianism are justice in acquisition and justice in transfer. In fact, these assumptions really represent the very core of the theory, and are the replacement for other "patterned history" schemes of distributive justice that are represented, in Nozick's (1974, pp. 156–157) view, by other non-libertarian approaches to fairness and justice. Simply put, if we assume that everyone is justly entitled to the distribution of property they actually have – that is, if the goods have been obtained through "justice-preserving" means of acquisition and transfer – then the demands of justice are satisfied, and there is no further need to examine distribution amounts, inequities, or redistributions (1974, p. 151). Given this assumption of an initial fair distribution,[6] free-market forces are proposed as the best way to govern future transfers, and actual distribution inequities are considered irrelevant as long as they are fair.

This, then, highlights the potential libertarian objection to CEO compensation: that the determination and distribution of such compensation might not meet the standards of justice in acquisition and justice in transfer. All of the subsequent libertarian tenets – individual responsibility, free and unfettered market-transfer mechanisms, individual consumer liberty – cannot even be meaningfully applied to questions of executive compensation if the process of paying CEOs violates justice in acquisition or transfer. Because Nozick argues that a thief is not entitled to his ill-gotten gains, it follows that executives who use an insider's advantage to enrich themselves at the expense of other stakeholders also do not attain just entitlement; such a situation scarcely looks like free exercise of liberty in action. From this standpoint, it is not the disparity (or result) of the pay distribution that fuels the objection; rather, the process that is less than fair and transparent. Recall the case of Richard Grasso in which the state of New York is attempting to recover a portion of Grasso's compensation because he allegedly exploited his position by deceiving his compensation committee about the details of his pay package (Thomas, 2004), a process deemed to be unfair.

Although these three theoretical traditions raise additional fairness-based objections not discussed here, the most consistent, convergent idea arising from these normative perspectives is that the *process* must be fair. Unlike the first two objections to CEO

compensation (based on either its absolute or comparative magnitude), an objection to the fairness of executive compensation potentially has strong validity. At the very least, analyzing the fairness and justice of CEO pay suggests that current standard-practice processes for CEO selection and compensation may be indefensible and should be reexamined.

Objection #4: incentive pay for CEOs does not work

While fairness is an important consideration for executive pay, a final objection involves its efficacy. The way CEO pay is structured is intended to solve the agency problem that exists between stockholders and corporate managers; to assure an increase in shareholder returns, scholars have recommended reward systems that link CEO compensation to firm performance (Jensen and Murphy, 1990b). Although scholars have disagreed about some details, CEO stock options are typically assumed to ameliorate the agency problem, and such incentive structures remain a best practice promoted by compensation consultants. Incentive pay presumably aligns the interests of shareholders and management, eliminating the problem of malfeasance and boosting firm performance in favor of their joint interests. Hence, an objection about its efficacy might best be phrased as a question: Does incentive pay for executives work?

Although empirical evidence indicates that agency considerations indeed play a key role in the *determination* of most executive pay (Garen, 1994), evidence of the *effectiveness* of such compensation arrangements is another matter. At best, incentive compensation has an ambiguous relationship with firm performance that can reward executives for luck (Bertrand and Mullainathan, 2001), or encourage CEOs to manage their personal reputations rather than their organizations (March, 1984). Research indicates that current forms of managerial incentive pay do *not* effectively align the incentives of managers and shareholders; indeed, a number of studies have had difficulty showing any positive link between executive incentive pay and improved performance of the firm (e.g., Mishra et al., 2000; Murphy, 1999), and some work suggests that high CEO incentive pay or perquisites may in fact *decrease* firm performance (Blasi and Kruse, 2003; Core et al., 1999; Yermack, 2006).[7]

As a corollary to these troubling results about the disconnect between incentive pay and firm performance, it also appears that incentive alignment does little to alleviate concerns about malfeasance and self-dealing. While incentive pay is traditionally seen as an alternative to monitoring as a way to prevent managerial misconduct (Tosi et al., 1997; Zajac and Westphal, 1994), empirical results do little to confirm the claim that malfeasance is reduced. Indeed, recent research (Harris and Bromiley, 2007) investigates whether large potential payoffs for managers – contrary to classically formulated incentive theory – do *not* supply an adequate incentive for the good management practices that scholars typically suppose, but rather provide an enticement to cheat, commit fraud, or otherwise cook the books in an attempt to fabricate the levels of corporate performance that will trigger the payoff. Harris and Bromiley argue that conventionally formulated theories are naïve in presuming that managerial responses to incentives are limited to actions that build true value for their firms, assuming away the possibility of managers instead of manipulating reported performance in order to trigger the incentives. Once you allow for such a possibility, acknowledging that incentives may prompt unethical conduct, the relative magnitude of incentives should also serve as a predictor of financial misrepresentation, a result strongly confirmed by the data in their study. The authors demonstrate with strong large-sample evidence that high levels of executive stock option compensation substantially increase the probability of corporate financial misrepresentation.

In addition, the analysis reveals that monitoring practices typically considered measures of 'good governance', including independent board members and institutional stock ownership, have no effectiveness whatsoever in deterring the misconduct. Whatever the potentially positive effects these governance practices may possess, they are completely overwhelmed by the motivating power of incentive pay, whose effect is shown to be dramatically nonlinear; for instance, a firm that pays over 92% of total CEO compensation as stock options has nearly a 40% chance of an accounting restatement in a subsequent 10-year period.

Furthermore, this type of misconduct, once discovered, has a dramatically negative impact on subsequent firm performance (Harris, 2007). Financial misrepresentation leads to diminished financial performance, and this detrimental performance impact is observable not only in the typical short-term stock price fluctuation that analysts expect, but also in the ongoing and long-term impaired *operational* profitability of the firm. Apparently, key stakeholders of the misrepresenting firms care a great deal about ethical impropriety, and the misrepresenting firms take a massive body blow to their accounting profitability; on average, a firm starting with a return on assets of 0.12 (the average value of premisrepresentation returns in the sample of firms analyzed) drops to 0.056, losing 46% of its accounting profitability, for one and, in some cases, up to two years. This result links back to the previously discussed troubling relationship between CEO pay and firm performance; substantial value destruction is linked to financial misrepresentation, which, in turn, is shown to arise from executive incentive pay, illustrating one causal path by which incentive pay can eventually impair performance (Harris, 2008).

Therefore, as with fairness-based objections to executive compensation, concerns about the actual efficacy of CEO incentive pay appear to be well-founded. At the least, traditional scholarly assumptions about the effectiveness of incentive alignment in solving agency concerns should be re-examined. Research suggests that CEO incentive pay may be much less effective at improving firm performance and minimizing malfeasance than traditional organizational theory suggests.

Conclusion

In conclusion, several common objections to CEO pay – objections based on absolute or comparative magnitude – have little validity, whereas several other objections that question the fairness or effectiveness of executive compensation have considerable strength. This suggests that critiques – whether in academic or public discourse – ought to focus more on fairness and effectiveness concerns and less on sensationalizing the size of CEO pay packages. Regulatory initiatives motivated (either implicitly or explicitly) by objections to the magnitude of executive pay tend to take the form of increased disclosure requirements; not only do such efforts address the wrong problem and are therefore misguided, but increased disclosure is, paradoxically, unlikely to be a diminishing force on executive pay trends in any event and has the potential to backfire.[8] Of the potential objections to executive pay, scholarly and regulatory efforts should focus more acutely on the substantive concerns of efficacy and fairness.

Notes

[1] "The major development in the labor market in recent years has been the stunning disconnect between the rapid productivity growth and pay growth, especially given the rapidity of productivity's growth and how stunted pay growth has been in the last several years. Also of great concern is the tremendous widening of the wage gap between those at the top of the wage scale, particularly corporate chief executive officers, and other wage earners … A historical look at wage inequality shows that it has worsened considerably over the past three decades … The very highest earners have done considerably better than other workers for at least 30 years, but they have done extraordinarily well over the last 10 years" (Mishel et al., 2007, pp. 4–5).

[2] See Harris (2006) for a more thorough analysis of the ethics of executive pay from the standpoint of these normative theories of distributive justice.

[3] Khurana (2002, p. 187) methodically describes the CEO selection process, compellingly illustrating the extent to which it "deviates in critical ways from the kinds of markets described by neoclassical economics." As such, CEO selection and pay outcomes are far from being optimal and fair, for a variety of reasons discussed only briefly here, but explored in more descriptive depth in Khurana's (2002) analysis, especially in chapters two and seven.

[4] For example, the perspectives of Sen and Nussbaum are much more intuitionist in nature than the constructivist approach of justice as fairness. Although their conception of the person is roughly similar to that of Rawls, it includes some ideas that are almost Aristotelian; a conception that views people as agents who have a hand in their own destiny, who have many and diverse interests, who require freedom to achieve their own version of a valuable life, and who are all equally interested in and deserving of such ideals. Freedoms, in this view, are essentially the capabilities to do the things

that are central to this conception of personal development and fulfillment.

[5] Despite fine-grained differences in the theories of Sen and Nussbaum, they are sufficiently similar and complementary that I consider them together here.

[6] Nozick explicitly acknowledges that, in the real world, these underlying assumptions sometimes do not hold:

> Some people steal from others, or defraud them, or enslave them, seizing their product and preventing them from living as they choose, or forcibly exclude others from competing in exchanges. None of these are permissible models of transition from one situation to another. And some persons acquire holdings by means not sanctioned by the principle of justice in acquisition (1974, p. 152).

He goes on to explain how these problems give rise to the sticky dilemma of past injustices and how to correct for such things. Despite raising the issue, however, Nozick quickly assumes it away, offering as a solution only the mere possibility of an unspecified ''principle of rectification'' that would ''presumably'' remedy such situations (1974, pp. 152–153).

[7] For example, Blasi and Kruse (2003) find that from 1993 to 2001, the quartile of companies that gave the smallest shares of options to top management gave their investors a 31.3% annual return. Shareholders of the quartile of companies that gave disproportionately to top executives received only a 22.5% return.

[8] See Cain et al. (2005) for an empirical analysis and discussion of how disclosure can often exacerbate the very problems it intends to address.

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