# TOO BIG CEO COMPENSATION

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## TOO LITTLE SOCIAL RESPONSIBILITY

**By Pushpa Kumari**

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## Economic Policy Dialogue

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## Executive Summary

Present paper reveals how very high and yet increasing pays of the CEOs as compared to other workers is a social ill. It determines that 'rent seeking behavior' seems to better explain the CEO pay phenomenon than 'pay for performance'. On the whole, it establishes that it is not only the amount of the CEO pays, but also the process and the impact, all reflect the socially irresponsible behavior on the part of CEOs.

A huge inequality is not good for the workers, society and national economy. It adversely affects the morale of the employees, leads to an unequal wealth and associated power distribution in a society, spoils the social fabric, and also reflects dominance in an overall institutional dynamics of a nation. Corporate world's reckless conduct under the leadership of recent time CEOs, like cost cutting, hire-fire, job-diversions, no union or de-union, excessive risk etc. may be financially paying but have too high social costs to bear by any society. Excessive pays have created, in general, an excess risk-taking, greed, market manipulation, exploitation, fraudulence and corruption. This, in turn, has caused more mistrust against the corporate world on the one hand, and greater instability in the national economies and further unsustainably in the global economy on the other.

CEOs may grab excessive pay checks while sitting at a top responsible position but as an individual, as a part of an organization, and as a part of a society they can never be seen as responsible. In an era of corporate social responsibility consciousness, CEOs do have a parallel duty to be socially responsible and take out a proportionate share from the value added *vis-a-viz* other stake-holders, especially the fellow members. This is an irresponsible behavior to extract more than the socially acceptable pays.

Also, there seems to be no link or a poor, if any, between their pay and performance. The fact is executives have been able to extract much more than optimal with their power and influence. A pyramid of institutional factors like, inefficient markets, biased and loop-holed regulations and partisan nexus etc. serve a good landscape for opportunistic selfish-interests and greed to fructify. CEOs' pays might have been swallowed by the societies, but they cannot be accepted as socially responsible.

# 1- Introduction

Income inequality is not a new phenomenon at all, but ‘so much’ is not a very old either. The ratio of earnings of an average U.S. CEOs in major companies to an average worker ballooned 344 in 2007 from less than 40 till 1970s[1]. Canada is not far behind; the ratio was found to be the 5th highest (after US, UK, Italy and New Zealand) in a group of 14 advanced countries’ group in 2005[2]. The average earnings of the top 100 CEOs have risen to 174 times in 2008[3] from around 100 times than that of an average worker in just 10 years’ time. Such a high income inequality might have been swallowed by our societies, but whether it is a socially responsible behavior on the part of executives is a subject matter of scrutiny.

Present paper attempts to look into: a) how a large and increasing income gap between the executives and the workers is a social ill; b) how drawing the fat pays is not a socially responsible behavior on the part of CEOs; c) whether there is a correlation between executives’ pay and performance; and d) what explains executives’ enormous pays. Although present analysis intends to deal directly with a particular aspect of income inequality, i.e. between executives and workers in the industry; it may also be related with the issue of inequality in general, and with several other issues at industrial, socio-economic, and institutional level.

[1] Mishel (2009). Figure 3AE, p. 221. Also, Anderson (2009). p. 1.
[2] Mishel (2009). Table 3.42, p. 222.
[3] Mackenzie (2010). p. 5.

## 2- How Large Income-gap between CEOs and Workers is a Social Ill

A huge and yet increasing gap in the incomes of workers and their executive counterparts is a social ill as it is bad for the workers, society, democracy, and national economy.

- It adversely affects the morale of the employees, and consequently their efficiency and productivity. They feel as if their hard work not being rewarded proportionately. They face the harsh realities like a fall in unionization rate, hire-fire policy, joblessness, and increased part-time and contractual jobs in contrast with an ever growing CEOs' compensation. They are more vulnerable and insecure than ever as their bargaining power, welfare, and employment have become more susceptible. Demoralized, stressed and chilled working class has been watching fat cats accumulating more fat.

- It creates a perpetual cycle of imbalance in the social fabric through inequality. Workers live in a society where they relate themselves with others, especially more so in an organizational set-up. If they find themselves weakened or weakening in relation with others or even not grown at a pace at which others have, it affects negatively their social behavior. It may cause stress, over/under work, shirking, and behavioral volatility etc at the personal level; whereas, disturbed family relations, health problems, addictions, domestic/communal violence at the social level; and corruption, manipulation, insensitivity, discrimination, marginalization, crime etc at the national level. These three-leveled self perpetuating disorders (may or may not be interconnected) are certainly not driven only by the income-inequality, but it has its role in its dynamics.

- It also creates a bias in the macroeconomic decisions which further results a skewed resource and wealth distribution in a nation. It simply appears to be the income gap visibly, but through distribution of wealth it invisibly determines what, how and whom for is to be produced. Market forces simply follow where the profits are; profits are where a growing market and wealth is. Jeremy Rifkin writes in his seminal work ‘The End of Work’, “The growing gap in wages and benefits between top management and the rest of American workforce is creating a deeply polarized America – a country populated by a small cosmopolitan elite of affluent Americans enclosed inside a larger country of increasingly impoverished workers and unemployed persons. The middle class, once the signature of American prosperity, is fast fading….” [4] In Canada, perhaps, structural factors associated with inequality, among other factors, may explain the fact why the average real and relative federal minimum wage and also the average worker’s real earnings have actually fallen, whereas average real compensation of the top CEOs has increased enormously during the last two decades’. Estimates by Kerr (2008) show that although the average federal minimum wage increased by some 21% between 1997 and 2007, however, when adjusted for inflation, the average federal minimum wage has actually declined (less than 5%) during the same period, and also the relative average federal minimum wage declined during this period from approximately 42% of the average hourly wage for all employees 15 years of age and over in 1997 to 39% in 2007.[5] According to the calculations by Mackenzie (2010), the average real earnings have actually fallen by 6% for an average worker during 1998-2008, whereas average real compensation of top 100 CEOs has risen by more than 70% during the same period[6]. This is how, invisible hand of power works!

- It is inherently undemocratic in any democratic system. ‘Whose rules rule the nation’ – it is generally not the democratic institutions as it appears to be; rather, actually it is where the wealth and power are. Lobbyists, interest groups, public relation agencies, consultants, lawyers, etc middle agencies also play their role to serve the aspirations of those with power and wealth.

[4] Rifkin (1995). p.173.
[5] Kerr (2008). p. 3.
[6] Mackenzie (2010). p. 5.

- Large income gaps reflect opportunism of one group, and also incentivize to intervene and manipulate institutional structure to attain and maintain their monetary gains at any costs. In the process that small group may play with the peoples' livelihoods, organizational structures and economies' sustainability. "Executives' excesses" are one of the major factors behind the ongoing worst global recession since the great depression of the 1930s. Enron scandal, a case of "the systematic failure of America's institutions of capitalism"[7], is yet not a forgotten past in which one of the main responsible factors was the "excessive executive compensation"[8]. How many times the black-holed part of the corporate history has to repeat to convey the same message that executives' excesses cause greed, excess risk-taking, market manipulation, fraudulence and corruption.

[7] McNamar (2003). "Enron's management failed. Enron's board of directors failed. Enron's internal audit function failed. Enron's external auditors failed. Enron's attorneys failed. Enron's commercial and investment bankers failed. The credit rating agencies failed. Wall Street's securities analysts failed. The business press reporting on Enron failed. In other words, the institutions of American capitalism that many had touted, indeed even preached about to the rest of the world, simply all failed."

[8] Committee on Governmental Affairs, United States Senate (2002).

## 3- Is this a Socially Responsible Behavior of the Executives?

Whether CEOs' high pays indicate their social responsibility or not can be viewed on three possible grounds: as an individual, as a part of an organization, as a leader of an organization.

In an era of corporate social responsibility, CEOs also have analogous duty to be socially responsible and take out a proportionate share from the value added *vis-a-viz* other stake-holders especially fellow members. Unfortunately, being at a top executive position he seems to behave like a predator probably sitting at the top on the enormous resources of an organization and potentially knowing all the strong and weak links within it. While being privileged with a responsible position, he behaves relatively irresponsibly. Widespread attack on their compensations has been nothing but a signal of social unacceptability.

As a member of an organization several questions may be asked to look at the justification of the big pay amounts. Is a CEO irreplaceable? Will organization cease to exist if he is not the head? If he is paid less than what is currently, will he not work the way he works now? If he is paid in a certain reasonable proportion with other employees, will he work differently? History answers loud all these questions. National corporations have grown all over the world historically without present-time big compensations. Inventions, innovations and productivity all have taken place without such huge payments. Leadership is a passion, it is a skill – and not bound by the amount of compensation. Yes, reward is an inducement but how much reward is good – is a matter of corporate introspection. Excess rewarding has been creating nothing worth rewarding but excess risk-taking, greed, market manipulation, exploitation, fraudulence, and corruption. In return, on a one hand this has caused more mistrust against the corporate world, and on another greater inherent instability and volatility in the national economies, and further unsustainably in the global economy. In no way, this can be termed as a socially responsible behavior.

CEOs enter an implicit social contract, as they join any organization bound by such contract. How far all the stake-holders, especially other than the shareholders and employees, like buyers, suppliers, regulators, governments, communities, environment, and economy have been fared in the value-generation process? Wide range of criticism and increasing activism against bully corporations indicate that CEOs' report-card, who run these corporations, is certainly not clear.

George Romney, General Motors CEO, turned down a $100,000 bonus and kept his salary at $225,000 a year in the late 1970s while declaring that no executive should be paid more than 25 times the factory wage[9]. Warren Buffet, chairman of Berkshire Hathaway, received a total of $175,000 in compensation in 2008, the same amount he received a year earlier[10], and also having base salary at $100,000, the same level it has been for more than 25 years. As Charlie Munger, Warren Buffett's partner at Berkshire Hathaway, puts it, "The CEO has an absolute duty to be an exemplar for the civilization."[11]

[9] Example is quoted in Mackenzie (2009)
[10] Bernard (2009). San Diego Union-Tribune 13 March 2009.
[11] Kirkland (2006). Fortune June 30 2006.

# 4- Are Performance and Reward Correlated?

Theoretically, higher pay ought to be paid for higher performance; hence there should be a strong correlation between compensation and profit. But simple cross section data analysis with the help of correlation coefficients for the top 100 companies in 2008 and 2009 do not indicate the same. An important observation to note: about 70 CEOs of these top 100 companies were also found as among the highest paid 100 CEOs list in 2009[12]. It means our analysis, based on the compensation of the top companies' CEOs, is in the best approximation of the highest paid CEOs in the Canada's corporate world.

In 2008, correlation coefficient between CEO compensation and company's profit was found to be 0.29 which cannot be considered to be strong in any ways, and correlation coefficient between executive compensation (in 2008) and percentage change in company's profit (from 2007) was found to be negative for the 102 executives of the top 98 companies[13]. Whereas in 2009, these correlation coefficients fared worse as being calculated at 0.09 in the case of CEO compensation and company's profit, and -0.21 in the case of CEO compensation (in 2009) and percentage change in company's profit (from 2008) for the 103 executives of the top 100 companies.

**Correlation coefficients**

| Year | Correlation between Compensation & Profit | Correlation between Compensation & % Profit Change from Previous Year |
|---|---|---|
| 2008 | 0.29 | -0.09 |
| 2009 | 0.09 | -0.21 |

Note: Data on CEO compensation, profit and percentage change in profit are taken from 'Globe and Mail' 2009 & 2010 lists on executive compensation and 1000 publicly traded companies.

Actually, 39 out of top 98 companies in 2008 and 61 out of top 100 companies in 2009 experienced negative change in the profit from their respective preceding years. Also, out of 39 and 61 'negative profit change' companies during 2008 and 2009, respectively, three companies (Magna International Inc., Power Corp. of Canada, IGM

[12] Comparison between the 'Top CEO Listing' in Mackenzie (2011) and 2010 Globe and Mail 'Executive Compensation Survey'.
[13] Not 104 CEOs of 100 top companies as in the original 'Globe and Mail' CEO compensation list because data on two companies – Tim Horton and Pengrowth Energy Trust – were not complete.

Financial Inc.) had two executives each in both years; however in other companies with positive change in profit, there was one company (Research In Motion Ltd.) with two executives. Surprisingly, 6 (out of these top 98) companies in 2008 and 10 (out of top 100) companies in 2009 actually incurred losses. There may be an argument that slow-down in the global and domestic economy during these two years of 2008 and 2009 had affected the performance of these companies. But during bad times and bad corporate performance, if executives' pays were as usual – this raises more question marks on the integrity of the executives.

## 5- What Explains So High Executives' Pays, if not the Performance?

Weak correlation in the above cross-section data analysis shows that there is a poor link between pay and profit. Therefore higher pays are not for higher performance, but for something else. Current higher pays in an expectation of higher future profits (as to mend current low profitability) – might buy the argument in some but not in the majority cases. Dissonance between executives' pay and performance has attracted loads of academia's attention[14] too. This phenomenon has been described with different terms, for example, 'agency problem' [15] 'board capture' [16] 'managerial power' [17] 'rent-extraction'[18], 'appropriation or skimming'[19], and 'pay-for-luck'[20]. All such terms refer to

[14] "Indeed, the increase in academic papers on the subject of CEO compensation during the 1990s seems to have outpaced even the remarkable increase in CEO pay itself during this period (Murphy, 1999)." Bebchuk and Fried (Summer 2003). p.71.

[15] "When ownership and management are separated in this way, managers might have substantial power. This recognition goes back, of course, to Berle and Means (1932, p. 139) who observed that top corporate executives, "while in office, have almost complete discretion in management." Since Jensen and Meckling (1976), the problem of managerial power and discretion has been analyzed in modern finance as an "agency problem."" Bebchuk and Fried (Summer 2003). p.71.

[16] Thomas (2004).

[17] Quotes from following sources:

"In contrast to the optimal contracting approach to executive compensation by which pay arrangements are set by a board of directors that aims to maximize shareholder value, managerial power approach suggests that boards don not approach at arm's length in devising executive compensation arrangements; rather, executives have power to influence their own pay, and use that power to extract rents." Lucian, Fried and Walker (2002). p.751.

"Under this approach, which we label the "managerial power approach," executive compensation is viewed not only as a potential instrument for addressing the agency problem but also as *part* of the agency problem itself. As a number of researchers have recognized, some features of pay arrangements seem to reflect managerial rent-seeking rather than the provision of efficient incentives (for example, Blanchard, Lopezde-Silanes and Shleifer, 1994; Yermack, 1997; and Bertrand and Mullainathan, 2001)." Bebchuk and Fried (Summer 2003). p.72.

[18] "As a result of such deviations from optimal contracting, executives can receive pay in excess of the level that would be optimal for shareholders; this excess pay constitutes rents." Lucian, Fried and Walker (2002). p.754.

[19] "…such Studies are by Bertrand and Mullainathan; Benz, Kucher, and Stutzer; Blanchard, Lopez-de-Silanes, and Shleifer; and Yermack" As quoted in Lucian, Fried and Walker, (2002). Footnote, p. 755.

[20] "While the typical compensation package includes stock options in order to motivate the manager to increase shareholders' wealth, it is not clear how managers should be compensated when a firm's value increases as a result of general stock market movements and not from managerial effort (Jensen and Murphy, 1990)." Paligorova (2008). p. 2.

"However, compensation based on absolute share price performance rewards managers even when the managers' efforts have not contributed to the share price increase. In particular, the share price increase might be driven solely by factors external to the firm—such as changes in the economy that benefit the firm's industry or interest rate declines that benefit the market as a whole. One study of U.S. stock prices over a recent ten-year period reports that only 30 percent of share price movement reflects corporate the same premise that executive pay is above than for an actual performance, and therefore implicitly suggest that there is a need for it to be fixed.

Theoretically, executives' performance which is associated with the company's performance should be assessed from the long term value of the company. Society and national economy are also supposed to be benefitted in the process from the higher level of goods & services, income and employment. But perhaps developments in the executives' compensation structure, among other factors, have generated a system where corporate performance has in fact been in conflict with corporate long term value creation, social interests, and national economy's sustainability.

Short-termism, manipulations and cronyism have actually taken over the executives' real performance horizon. The performance barometer is now generally associated with the revenues or the stock values, which otherwise should have been tied to the rate of return on invested capital[21]. The downsizing, outsourcing, off-shoring, business sell-off etc. have come as handy tools[22] to prove quick business performance. Corporate book-cooking[23] and stock-engineering are another ways to manipulate the performance. Memories are still fresh of a series corporate accounting scandals like Enron, WorldCom, Tyco International, and Adelphia which led to the Sarbanes-Oxley Act, NYSE and NASDAQ regulations of 2002 mandating independent audit, nomination, and compensation committee etc. About stock market, it is worth mentioning a quote from the Joe Nocera's report (in the New York Times of October 13, 2007) which he took from Key and Putten's book "Myths and Realities of Executive Pay" (published by Cambridge University Press in 2007):

performance, with the remaining 70 percent driven by general market conditions. Because of such external factors, even managers who perform poorly—and whose actions therefore make shareholders relatively worse off—can profit when their compensation is linked to changes in the absolute share price." Lucian, Fried and Walker (2002). p. 797.
"Compensation dollars could be much better targeted if execu-tives received these dollars only to the extent that the increase in their firm's share price was due to firm-specific performance, rather than sector or general market performance." Lucian, Fried and Walker (2002). p. 796.

[21] Tedesco (2009). Financial Post Feb. 18, 2009.

[22] Nocera (2007). New York Times 13 Oct. 2007. Also, Collins (2009). Miami Herald 9 Sep. 2009.

[23] Collins (2009). Miami Herald 9 Sep. 2009.

"It is not a coincidence that the Dow Jones industrial average, which stood at 5,000 in 1996, is now well above 13,000," the authors write. "While U.S. executive pay practices do not entirely explain this rise, there is little doubt that it would not have occurred without them."

Executives' pay has been now no more an actual performance price of the agents (executives) that are to be fixed by a competitive compensation market and paid by the principal (the board representing the shareowners). However, neither the compensation seems to be a price for an executive's real performance nor does market seem to be competitive. The executive compensation, basically devised to address the agency problem between the managers and shareholders, actually has become as part of the problem itself, as boards "with dispersed ownership do not bargain at arms' length with managers, and that managers are able to influence their own pay arrangements".[24] About the compensation market, two quotes seem to be contextual:

"…the market for executive compensation is so clearly rigged. Chief executives sit on one another's boards, so they have an incentive to take care of one another. Directors are predisposed to want to make the chief executive happy since, after all, he or she is the one who picked them for the board. Far too often, a chief executive's pay isn't a result of an arms-length negotiation, but a result of a kind of a corporate buddy system." Joe Nocera (2007)

"To make matters worse, the Compensation Committee's advisors, usually paid consultants from a handful of well-known firms, have conflicts of interest that preclude them from giving truly disinterested advice. They tell directors to rely upon industry surveys of pay levels that have the (un)intended consequence of constantly ratcheting executive pay levels upward." Thomas (2004) p.1174.

Therefore higher pays are not for higher performance. 'Rent seeking behavior' is a better explanation than the 'pay for performance'. CEOs seem to exercise power and influence in their compensation contracts, and then use short-cuts like short-term oriented strategies and manipulating tactics to prove pseudo performance to extract that rent through. A pyramid of institutional factors like, inefficient markets, biased and loop-holed regulations and partisan nexus etc. serve a good landscape for opportunistic selfish-interests and greed to fructify.

[24] Bebchuk and Fried (April 2003). Abstract.

## 6- Conclusion

Very high and yet increasing pays of the CEOs has created an enormous income-inequality between the executives and other employees which is a social ill. This huge inequality is not good for the workers, society and national economy. It adversely affects the morale of the employees, leads to an unequal wealth and associated power distribution in a society, spoils the social fabric, and also reflects dominance in an overall institutional dynamics of a nation which is undemocratic inherently. Corporate world's reckless conduct under the leadership of recent time CEOs, like cost cutting, hire-fire, job-diversions, no union or de-union, excessive risk etc. may be financially paying but have too high social costs to bear by any society. Excessive pays have created, in general, an excess risk-taking, greed, market manipulation, exploitation, fraudulence and corruption. This, in turn, has caused more mistrust against the corporate world on the one hand, and greater instability in the national economies and further unsustainably in the global economy on the other.

CEOs may grab excessive pay checks while sitting at a top responsible position but as an individual, as a part of an organization, and as a part of a society they can never be seen as responsible. In an era of corporate social responsibility consciousness, CEOs do have a parallel duty to be socially responsible and take out a proportionate share from the value added *vis-a-viz* other stake-holders especially the fellow members. This is an irresponsible behavior to extract more than the socially acceptable pays. Also, there seems to be no link or a poor, if any, between their pay and performance. In a cross-section correlation analysis, a low coefficient between 'executive pay and annual profit', and also a negative coefficient between 'executive pay and percentage annual change in profit' were found during 2008 and 2009. 'Rent seeking behavior' seems to better explain the phenomenon of high and ever increasing executives' pays than 'pay for performance'. The fact is executives have been able to extract much more than optimal with their power and influence. In no way, this can be termed as a socially responsible behavior.

True for the executives: who care for the interests of the workers, society, nation or globe; we show you the figures, you give us the pay checks. But, we do care for these, and that is why we see the CEOs' too big pay checks as too little social responsibility!

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