The Washington Post

Back to previous page

Steven Pearlstein: Why they’re winning on CEO pay

By Steven Pearlstein,

Whatever you might think about the now-bollixed contract negotiations between the Washington Nationals and Jim Riggleman, it is a textbook example of an arms-length bargaining process between an employee looking to get the best job at the highest salary and a company looking to get the best manager at the lowest price.

In that respect, it bears no resemblance to the way big corporations go about negotiating a contract with a top executive. In most cases, boards of directors decide who they want and convey their decision to the lucky candidate or the executive whose contract is up for renewal. It’s only then, after the company has essentially given away its bargaining leverage, that the salary negotiation begins. Seizing his advantage, the executive asks for an outrageous pay package and after some gentle shadow boxing agrees to accept something slightly less.

So begins the escalation of chief executive pay.

The data from this spring’s proxy season is mostly in and it shows that after two years of decline, the average compensation for chief executives of the 500 largest U.S. corporations is on the rise again. According to Governance Metrics International, the average “total realized compensation” (salary, bonus and benefits plus any value realized from the exercise of stock options and vesting of stock grants and retirement benefits) was just under $12 million in 2010, up 18 percent from 2009 but still below the $15 million peak in 2007.

If you believe, as the corporate crowd apparently does, that this market for corporate talent is competitive and efficient, then you must also believe two things: First, that none of these guys (and the vast majority still are guys) would do the same job for a nickel less. Second, that the value of the chief executive went up 18 percent last year while the value of average workers in their companies changed very little. And if you believe that you are a fool and an ideal candidate for an open seat on an S&P company board of directors.

We’ve been having this argument about executive pay for 30 years, and we’re still pretty much where we began: Executives think the market has affirmed that they are worth every penny of what they get, and the rest of us think they’re grossly overpaid.

By my lights, the best academic work on this subject has been done by two law school professors, Lucian Bebchuk and Jesse Fried at Harvard, who unlike most finance professors understand that the market for executive compensation is essentially rigged. Their studies have found that the top five executives capture about 10 percent of the net profits of large public companies, up from about 5 percent in the early 1990s, which means that it has a material effect on shareholders. More significantly, they have run the numbers and found that chief executive pay correlates negatively with the profitability and market valuation relative to book value. Put more simply, the firms with high CEO pay turn out not to be the best performers.

Despite this compelling evidence, and the unambiguous public outrage, all the attempts to correct the excessiveness of executive compensation have pretty much made things worse or failed.

Requiring public companies to disclose compensation for top executives — and, more recently, a requirement that this pay be compared to "peer group" companies — seems to have simply sparked a determination in the companies that paid below the average to bootstrap themselves into the top half of the rankings. After all, what company wants to think of itself as "below average." Of course, only in Garrison Keillor's mythical Lake Wobegon can everyone be above average, and this ratcheting dynamic has probably been the biggest factor in pay inflation.

Several years back, someone came up with the bright idea of setting a million-dollar cap on how cash compensation could be deducted as business expense on corporate tax returns. So boards and executives granted stock options and restricted stock, on the theory that this would better align executive interests with those of the shareholders.

As it turned out, the size of the stock-and-option packages were so extravagant that executives wound up making tens and even hundreds of millions of dollars, often for no other reason than the stock market rose, or oil prices soared or they were able to goose the stock price through leveraged acquisitions or share buybacks. In other cases, the big stock holdings encouraged executives to take undue risks that led to massive decline in shareholder value — but not before they cashed in enough shares to be set for life.

This year, as part of the Dodd-Frank financial reform law, companies for the first time were required to give shareholders a chance to vote up or down on executive pay in a nonbinding tally. So far, 98 percent of the votes have gone in favor of the pay packages. It turns out this has little to do with ordinary investors, but rather the reality that most shares are voted by fund managers — mutual, pension, hedge and others — who are likely to be the last people on the planet to challenge excessive pay since it would call into question the equally excessive pay scales on Wall Street.

Just last week, the Republican on the House Financial Services Committee voted to repeal another Dodd-Frank provision that would require companies to calculate and disclose the ratio between the compensation of the chief executive and that of the "median" worker in the company. Although there are some tricky methodological issues to iron out, the business community and its Republican spear carriers on Capitol Hill have whipped themselves into a righteous frenzy about this innocuous requirement, citing the great burden it will impose and how it is discouraging companies from creating jobs.

As it turns out, a few companies do this voluntarily, among them Whole Foods, which when I last looked was growing and creating jobs like crazy. An executive there characterized the cost and hassle of making the calculation as "not significant." To reinforce its culture of teamwork and egalitarianism, Whole Foods limits the compensation of its chief executive to 19 times that of the average "associate." It's an idea first proposed in 1984 by that "radical" management thinker Peter Drucker.

The other big argument against the pay ratio disclosure is that it will vary widely by industry and corporate structure and thus could lead people to make invalid comparisons between companies. The same, of course, could be said of debt-to-equity ratio, gross profit margin and return on equity. The fact that some people might misinterpret such information hardly justifies not disclosing it.

The real reason companies don't want to disclose the ratio is that it would be used by labor unions, corporate critics and journalists to embarrass executives who, as far as I can tell, are beyond being embarrassed. (See my colleague Peter Whoriskey's wonderful piece about Dean Foods in last Sunday's Post.) After years of criticism, they have decided that the higher pay is worth whatever cost it carries in terms of worker disenchantment and public disapprobation.

The better argument against the pay-ratio disclosure is that there's not much more that can be learned from such disclosures. We already know from numerous studies that chief executives of large U.S. corporations make hundreds of times what an average worker makes, with the gap growing steadily wider. We also know it's possible to run successful advanced market economies with large corporations where the ratio is 25-1 (Britain), 13-1 (Sweden), 11-1 (Germany) and 10-1 (Japan). Whether the ratio at Exxon-Mobil last year was 320-to-1 or 276-to-1 seems rather beside the point.

Harvard Business School professor Rakesh Khurana has done extensive research on the value chief executives bring to large organizations, concluding in his excellent book, "Searching for a Corporate Savior," that it is vastly overstated by executive pay packages.

"I was pretty naive," he said. "I thought that once the facts were presented and there was reasoned discussion, corporate behavior would change." Alas, it hasn't turned out that way.

Khurana cites the old wisdom is that the simplest explanation is often the best one. "This is really a story about power: private power, the power of the economic elite, has trumped social norms, has trumped political power."

It's like this: Unless we are prepared to stop working at companies that overpay their executives, investing in them and buying from them, there's little hope of restraining executive pay. The reason they prevail is not only because they have the power, but because they care more about winning than we do.