Companies Must Come Clean on Executive Pay

The Sunday Times
By Irwin Stelzer
January 22, 2006

IT is some time since I sat opposite the chief executive of a big oil company at a seminar in which I suggested that shareholders should know how much they are paying the chief executive to run what is, after all, their company. He was more than a little annoyed. If everyone knew how much he earned, kidnappers would be tempted to snatch him in the hope of netting a big ransom. Besides, his friends on the compensation committee are responsible men, as he learnt when he served on their boards.

My adversary will be unhappy that the Securities and Exchange Commission (SEC) is proposing fuller disclosure of executive compensation. Christopher Cox, SEC chairman, told the press: "Our purpose ... is to help investors keep an eye on how much of their money is being paid to the top executives who work for them." He might have added three other purposes.

One is to begin restoring the reputation of an SEC that had not been as vigilant as it might have been while the Enron, WorldCom and other fiascos were brewing.

A second is to claw back from Eliot Spitzer, the New York attorney- general, some of the authority, and headlines, that Spitzer gained when he moved against abuses in the financial-services industry that the SEC had long tolerated.

Cox's third unstated goal was to defang critics who charged that President George Bush appointed him to appease businessmen who sought a period of benign neglect from their regulator.

Executive pay is a problem because of the very nature of the modern corporation. The dispersion of ownership of shares in large companies turns effective control over those enterprises to the managers. That creates what economists call the principal-agent problem: the share owners' agents, the executives, have incentives to behave in ways that are not in the interests of the principals they represent.

The pervasive nature of the problem became clear in the 1980s, when corporate raiders seized control of several companies, in effect reuniting ownership with control. The result: cost cutting and profit maximisation, as the need to pay off the debt incurred during the raid took precedence over company jets, wine cellars and golf-club memberships all hidden portions of executive pay.

But the problem is still with us. Most shareholders have little hope of influencing executive pay. And despite increasingly active institutional investors, pay is subject to three abuses at which the

SEC has taken aim the first directly, the other two indirectly.

The first is the lack of transparency. It is virtually impossible to determine from company reports just how much executives are being paid. In part this is due to the complexity of compensation packages, which include, in addition to ordinary salary, pension plans that Lucian Bebchuk and Jesse Fried in their book Pay Without Performance estimate can add more than a third to the total package; the company's assumption of some of its executives' tax liabilities; and a host of perks that are rarely mentioned.

In the now-famous case of GE, it took a divorce to bring to light the New York apartment, jet privileges, Red Sox tickets and country-club memberships that it had conferred on its former chief, Jack Welch. It ain't the perks, it's the cover-up that hurt Welch and GE.

The second possible abuse relates to the process of determining the pay package. Typically, the consultant hired to advise the compensation committee bases his recommendation on the earnings of the executive's peers. Since every board thinks it has hired an above-average executive, the package will be generous--and become the benchmark against which the pay of other executives is measured. Result: a ratcheting up as every board seeks to compensate its executives at above- average rates. Presumably, the transparency the SEC seeks would prevent that process from producing outlandish results.

The problem is compounded when the chief executive hires the consultant, who lusts after additional lucrative assignments that are in the gift of--you''ve got it--the chief executive whose salary the consultant is called on to recommend.

The third abuse, and one the SEC also hopes can be reduced by transparency, is the lack of a relationship between pay and performance. This is not easily solved, since separating the chief executive's contribution to his companys performance from the contribution of general economic and industry trends is difficult. But it is a problem worth solving, if for no other reason than to avoid situations in which the value of a company and the size of its executivescompensation persistently move in opposite directions.

There are two ways to fix the problem. One would be to put some ceiling on executive compensation. As the gap between executive pay and shopfloor pay has widened, pressure to do just that is increasing, for two reasons.

First, it sometimes is the case that the chief executive who has the unfortunate chore of laying off staff receives large bonuses for improving profitability, making it seem as if the capitalist system rewards the axe-wielder. Second, the gap between shopfloor pay and executive pay has been widening, as globalisation of labour markets bites into the pay of the average worker, while top executives benefit from the expanded global reach of their companies.

The better solution is to make the process by which executive pay is set transparent. That would subject compensation to the review of the shareholder-owners of the company, and to such restraints as institutional shareholders might be able to put on pay packages. And perhaps at least some executives who know their compensation will be a matter for public scrutiny even if they are never attacked by an angry spouse will rediscover the virtues of self-restraint in order to avoid Welch-style embarrassment. That's what Cox and his SEC team are hoping.

Irwin Stelzer is a business adviser and director of economic policy studies at the Hudson Institute

Available at: http://www.timesonline.co.uk/article/0,,2095-2003459,00.html