The Compensation Game

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Confronting greater media scrutiny and an ever-increasing number of shareholder resolutions focusing on executive pay, Corporate America continues to support current pay practices as a product of "the market." Not too long ago, former Treasury Secretary John Snow defended the dramatic rise of executive pay over time as a product of efficient markets and argued that the increase merely reflects the growing marginal productivity of chief executives.

Unfortunately, this standard defense reflects a broad misconception of both the CEO market and the nature of public concerns about executive pay. The idea that CEO compensation is driven by the invisible hand of market forces is a myth from which chief executives have long benefited.

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Like many other defenders of this phenomenon, Snow compared this trend to the soaring increase during this period in the compensation of other "stars," such as top baseball, basketball, and football players. Reports about the high pay of star athletes are often greeted with awe and approval rather than outrage. The rise of executive pay, its defenders claim, is no more problematic than the fact that, say, Red Sox slugger Manny Ramirez is paid much more than earlier stars like Ted Williams.

But the process affecting the compensation of star athletes is quite different from the one that determines CEO compensation. A team executive negotiating with an athlete can be expected to be guided by the club's interests, while the player's agent is looking out for the client's demands. When independent buyers and sellers hammer out a transaction this way, the market's invisible hand is commonly expected to produce efficient arrangements.

But in setting executive pay, as we document in our research, directors have not been guided solely by the interests of shareholders. Instead, they have had various economic incentives, reinforced by social and psychological factors, to go along with arrangements favorable to top managers. The nature of board membership, combined with the small size of the overall director community, results in a closed culture among people who share many relationships: those with whom board members are economically involved are the same as those with whom they are socially linked through shared status, organizational affiliations, and social standing.

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Compensation arrangements for sports stars lack the features of executive pay arrangements in other ways as well. After an athlete's compensation package has been negotiated, for example, clubs have little reason to try to camouflage the amount and channel it through arrangements designed to make the bottom line less visible. While athletes are paid generously during the period of their contracts, they generally do not receive much compensation through post-retirement perks and payments or deferred-compensation arrangements that serve to obscure total pay. And when clubs get rid of poorly-performing players, they do not generally provide them with the equivalent of a golden parachute—a payout that is common practice in the business world.

Because the CEO market is not, in fact, operating like others, the presumption that it will produce efficient outcomes is unwarranted. The problem is not just one of excess pay. Flaws in the pay-setting arrangements for corporate leaders have produced arrangements that dilute or even distort incentives. For example, executives continue to enjoy broad freedom to unload options, a practice that enables executives to benefit from increases in short-term stock prices that come at the expense of long-term value.

That the market for CEOs has not been operating like other markets does not mean that regulatory intervention should be welcomed. Rather, it suggests that directors must be given strong incentives to focus on shareholder interests. Directors should be made not only more independent of executives, as recent reforms have sought to do, but also more dependent on shareholders. To make directors focus on shareholders' interests, the processes that make it difficult for shareholders to remove directors should be dismantled.

Most of the public criticism of executive pay is not an attack on the capitalist system or the operation of free markets. Rather, it reflects a concern that because boards are insufficiently accountable to shareholders, the CEO market is not operating in a way that can be expected to produce efficient outcomes. Without real reform, compensation programs in the world of business and the world of sports aren't even in the same ballpark.

About the authors:

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