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Business World: Outrageous CEO Pay Revisited

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Controversy over executive compensation is with us always. It's with us in bull markets; it's with us in bear markets. It's with us when some executives, such as those at Tyco, are accused of supplementing paychecks with stealing, and when some like GE's Jack Welch come by their largess honestly.

Yet we never seem to get an intelligent explanation of a standout phenomenon of the business world, the vast increase in CEO pay over the past 15 years or so. The waxen stiffs of the evening news are satisfied with a single-word explanation: greed. But plumbers and hairdressers and commentators are greedy too. Greed being universal, it explains nothing about why CEO salaries skyrocketed and other salaries didn't.

Into the breach step three legal scholars, Lucian Bebchuk, Jesse Fried and David Walker. Their argument is that "managerial power" places top executives beyond any effective institutional check. CEOs basically dictate their own pay to supine boards, subject only to an "outrage constraint" -- i.e., bad publicity.

Such is the buzz value of the words "outrage constraint" that these musings have received endorsement from the editors of the Economist magazine and Paul Krugman, who calls them "must reading." But why bother? The argument is nothing more than a restatement of the greed hypothesis, propped up by a deus ex machina (the outrage constraint). It illuminates nothing. It merely puts an academic gloss on the yearned-for assurance that high CEO pay reflects moral failing on the part of CEOs.

To begin with, "managerial power" is hardly an original notion of the authors'. An identical assumption lies behind the conventional explanation of the explosion in stock-related pay: Let's dangle a large incentive in front of executives in hopes they will then be motivated to act in ways that promote a higher stock price.

The authors rebut this argument merely by referring to their own, insisting that stock options are just a ploy by CEOs and their board slaves to expand pay while evading the outrage constraint.

As seen here, the outrage constraint is an all-purpose, unfalsifiable explanation of any limit or condition on CEO pay. It serves as a polemical convenience, saving the authors from having to explain why executives don't use their "managerial power" to pay themselves infinitely large salaries for infinitely little work. As such, it's virtually meaningless. You might just as readily argue that any negotiation is determined by an "outrage constraint" that each side places on the other.

To be any use at all, their theory would have to explain why CEO pay has risen sharply. This would have to mean showing that managerial power increased, the outrage constraint declined, or both. Of course, the authors

have pleasured themselves with variables so vague as to be unmeasurable. But even so, the anecdotal evidence stacks up against them.

If managerial power has been on the rise, why are so many CEOs fired? Why has tenure fallen and turnover increased?

And why did some of the richest pay deals go to executives who hadn't been hired yet and therefore didn't have the hiring boards under their thumbs? We might mention examples like Mike Armstrong of AT&T, Conseco's Gary Wendt or Home Depot's Bob Nardelli. Did Joe Nacchio somehow bully his huge pay deal out of Phil Anschutz, the billionaire wheeler-dealer who created Qwest?

And what about the proliferation of short sellers, message boards and fund managers or the emergence of a larger and more sophisticated business press, all putting managerial power under more scrutiny rather than less?

On the other side of the coin, does anybody really believe outrage over CEO pay was in decline during the 1990s? The Democrats made CEO pay an issue in the 1992 presidential campaign and even passed a law to punish cash salaries to executives over $1 million. By 1996, virtually all the Republicans in the New Hampshire primary were falling over themselves to denounce "greed" and heartless layoffs. And what business publication doesn't run a critical, handwringing survey of executive pay every year?

The shriekingly obvious truth is that both CEO pay and outrage over CEO pay rose in tandem during the 1990s, the opposite of what the authors' argument would imply. Shareholders not only tolerated large CEO pay packages but in some sense even applauded them by driving up share prices amid growing publicity about the rewards being waved in front of executives in the form of stock options. And if the 1990s demonstrated anything, it's that any corporate behavior rewarded by higher share prices will keep coming in spades.

How to constrain managerial power has been a perpetual puzzle, and no doubt the power of executives is reflected in their pay arrangements. Certainly they bargain for as much pay as they can get, but this differentiates them from the rest of humanity how?

A real constraint the authors overlook is the dilutive effect on a company's stock price of an overhang of unexercised options. In turn, a real factor in towering CEO compensation has been the willingness of investors to fund these option grants by sustaining the share prices of the companies that issued them.

There's a consensus now that the worm has turned, that investors have become newly skeptical of the ability of lavishly incentivized celebrity CEOs to pull higher stock prices out of their hats. We'll see. We're in a mood right now to substitute the punishing daddy for other ways of controlling the corporation but at the end of the day jail threats and fines don't create wealth. It would be premature to assume we've seen the last of big fat carrots waved in front of corporate management.