In the money

Executives have enjoyed an astonishing pay bonanza. Edward Carr explains why most of them deserved it

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RIGHT and left, Americans and Europeans, stockmarket investors and anti-globalisation campaigners all share one belief: top managers pay themselves too much. The evidence seems to bear them out. For almost half a century the ratio of top executives' pay to median earnings was as smooth as a boardroom table. Then, starting in America in the 1980s and a few years later elsewhere, this ratio began to increase before taking off exponentially and peaking around the turn of the millennium (see chart 1). At that point the worker on an American shop floor was earning in a year roughly what his boss on the top floor took home each evening.

Most people think they know what lay behind this. Greedy chief executives, abetted by weak, sycophantic boards, gorged themselves at the expense of savers—more often than not the very pension and mutual-fund investors who, as workers, had seen their salaries and benefit packages fail to grow.

To add to the grievance, many executives did not seem to deserve such rewards. Extraordinary pay for great performance is fine, it is routinely said. But many executives have been paid a fortune for presiding over mediocrity. The Corporate Library, an American corporate-governance consultancy, last year identified 11 large and well known but poorly governed companies, including AT&T, Merck and Time Warner, where the chief executive had been paid at least $15m a year for two successive years even as the company's shares had underperformed. Robert Nardelli received a $210m pay-off when he lost his job earlier this month even though the shares of his company, Home Depot, fell slightly during his six years in charge. Carly Fiorina, ejected from Hewlett-Packard almost $180m better off—including a severance payment of $21.6m—after a lacklustre tenure as chief executive, let it be known in her autobiography that money was not important to her. Not everyone believed her.

Unappreciated

No wonder the standing of executives has fallen so low. A poll for Bloomberg and the *Los Angeles Times* last year found that 80% of Americans thought executives were overpaid. Even those sympathetic to business are unsympathetic to its leaders. In a second-year class at Harvard Business School quizzed by Ira Kay, head of the compensation practice at Watson Wyatt, a consultancy, two-thirds of the students were critical of bosses' pay. In a survey, Mr Kay discovered that fully 90% of institutional investors—ie, companies' owners—thought executives were “dramatically overpaid”. So did 60% of their directors. That is quite a confession, given that directors are the very people who decide how much managers should earn.

But the diatribe against executives is mistaken. Poor governance alone cannot readily explain some of the most striking features of pay over the past few years. To dwell on the undoubted

failures of governance is to gloss over the economic and corporate shifts that have been the main causes of the extraordinary rise in top managers' earning power.

National pay schemes vary greatly, and America remains ahead of, and more extreme than, other countries. (That, together with the superior quality of American data and the research they support, is why much of the material in this report is drawn from the United States.) But over the past decade all markets have displayed the same pattern: widening gaps between managers and workers and greater emphasis on long-term incentives. It is hard to see how this could have been caused by universally poor governance across so many different systems.

The chief mistake of the past 15 years was the granting of too many share options to too many people on terms that were too generous. That was costly and unwarranted, but it stemmed more from foolish accounting and tax policies supercharged by bull-market mania than from a sinister plot hatched in the executive suite.

This is not to deny the abuses and downright crookery that have marred executive pay. Even now, dozens of senior managers are under investigation for “backdating” their share options—illegally manipulating the timing of grants to increase the likelihood of a payment. Nor is it to assert that all is right in the boardroom. Indeed, the case for reform is strong.

It is, however, to argue that popular opinion is wrong. The lion's share of the executives' bonanza was deserved—in the sense that shareholders got value for the money they handed over. Those sums on the whole bought and motivated the talent that managed businesses during the recent golden age of productivity growth and profits. Many managers have done extremely well over the past few years; but so, too, have most shareholders.

Between 1993 and 2003 the total pay of the top five executives in the Standard & Poor's 1,500, which accounts for roughly 80% of listed American companies by value, amounted to some $350 billion, according to Lucian Bebchuk and Yaniv Grinstein, of Harvard and Cornell Universities. The share of earnings consumed by those people's pay rose from 5.2% in the first five years of that period to 8.1% in the second five. And this is without counting the value of pensions, which can boost the total by as much as a third.

That is a lot of money, to be sure—though not quite as much as it sometimes seems. The “average” pay that is often quoted, and which is used as the basis for comparison with the “average worker”, is the arithmetic mean. Chart 1 above, from a different study, shows the average earnings of the top three executives all the way back to the 1930s. Whereas mean pay at the peak was 320 times average earnings, the median pay was “only” 120 times. In 2000-03 their mean annual pay was $8.5m and the median $4.1m. The median is a better measure than the mean because the mean for those top three is skewed by a few huge payments, often to company founders or family managers who are not standard executives.

Although overpaying a chief executive on its own is unlikely to bankrupt a company, there are other reasons to care about top pay. One is incentives. The role of pay is not to get executives to work harder (most are workaholics already, toiling towards an appointment with the heart surgeon), but to recruit good managers and get them to take difficult decisions. Shutting a

subsidiary, sacrificing a pet project or forgoing a tempting acquisition is not much fun. Without the spur of high pay, managers tend to avoid such things.

Pay is also outsiders' most visible test of a board's capacity to monitor a company's executives. Mr Bebchuk, a fierce critic of the developments of the past few years, declares that “pay is not isolated: it is a classic board function important beyond just dollars.” If he is right that boards are unable to control pay, then poor governance is leaving managers free to use the company's assets for their own benefit. Excessive pay “undermines the notion that we can trust investment to managers and directors”, says Nell Minow, head of the Corporate Library. It becomes the justification for wide-ranging governance reform.

Lastly, executive pay is the most controversial aspect of the increasing inequality that has appeared over the past couple of decades. As the topmost echelon appears to be capturing a huge share of new wealth, everyone else's wages have barely shifted. This would be disruptive even if managers were felt to deserve what they are paid. It would be explosive if high pay continued to be seen as a swindle. Ultimately, businesses function with the blessing of workers, shareholders, customers and voters. If business leaders are universally seen as immoral and grasping, cynicism and mistrust will flourish and choke enterprise. Jeb Bush, a Republican former governor of Florida and no enemy of business, gave warning last year that “if the rewards for CEOs and their teams become extraordinarily high with no link to performance, then it undermines people's confidence in capitalism.”

Across the rich economies, governments have begun to demand disclosure of pay and new corporate-governance codes. In America's Congress Charles Grassley, a Republican and former head of the Senate committee on finance, is calling for boards to “do their job” instead of being “in hock” to managers. Barney Frank, the new Democratic head of the House financial-services committee, is likely to introduce a bill on pay.

All this makes business people extremely nervous. The difficulty is that they find it hard to discuss pay. (Imagine the talking point: “I am worth $100m because...”) Their case is seldom heard or examined. But “it is a societal problem,” says Jay Lorsch, of Harvard Business School. “If the business community doesn't do something, we are going to get more pressure from the federal government—and we don't want that.”

The arguments about pay are subtle and complex. They start with that moment in the 1980s when the long-established relationship between workers' and managers' pay began to break down. What could explain such a turning point?