CEO Pay Continues Its Crazy Upward Spiral

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The United States' economic recovery continues to limp and wheeze along, but that hasn't stopped CEOs from raking in millions in compensation and getting a big raise last year. The *New York Times* recently reported that median pay package of CEOs in 2012 was $15.1 million, a hefty jump of 16% from 2011. (Compensation included salary, cash bonuses, perks, and other forms of cash, and stock as well as stock options.)

As CEO pay continues to grow strong, the typical worker's pay in the U.S. has stagnated since the beginning of the recovery in 2009. The Economic Policy Institute (EPI), a nonprofit, nonpartisan think tank, found that in 2012 the ratio of CEO pay to employee pay was 273 to 1, or 202 to 1, depending on how stock options were accounted for. According to EPI, "escalating CEO compensation is a major contributor to income inequality."

As it should, corporate America is facing increasing scrutiny from the media and shareholders on the issue of rising executive pay. In recent decades, CEO pay, along with the pay of other senior executives, has risen dramatically. American CEOs now make twice as much as their counterparts in European countries.

The real nail in the coffin against such extravagant CEO pay comes when you look at the relationship between company performance and the size of CEO compensation awards. According to Harvard Business School professor James Heskett, "there seems to be little or no relationship." So why is corporate America paying so much?

Companies have defended their executive compensation schemes as products of the "market." Compensation levels, they claim, are driven by increasing marginal productivity of chief executives. Recent research has shown that argument to be a myth. The "invisible hand" of market forces isn't behind the dramatic rise in CEO pay. Rather, boards of directors — who set CEO packages — are influenced by "various economic incentives, reinforced by social and psychological factors, to go along with arrangements favorable to top managers," according to professors Lucian Bebchuk at Harvard Law School and Rakesh Khurana at Harvard Business School.

Despite pressure from shareholders, boards of directors are often reluctant to restructure executive pay packages. Several fears push compensation committees to keep CEO pay high: 1) They fear losing a high-performing CEO who might be lured by more attractive packages elsewhere; 2) Attracting a new CEO from the outside requires making appealing deals — that means not only high pay, but guaranteed "farewell" packages if things don't work out, often called the "golden parachute."

Despite public outrage, multi-million-dollar severance packages are still very much in vogue. Last year, the biggest package was awarded to James J. Mulva, the retiring CEO of ConocoPhillips, who had been with the company for a decade. He walked away with $156

million on top of salary, bonus, and other compensations that he got while working for the company.

The U.S. government has made efforts to increase regulation and oversight of executive compensation with the Dodd-Frank Act of 2010. Whether the Securities and Exchange Commission has the resources or wherewithal to enforce or oversee the Dodd-Frank Act is unclear. And currently, legislation is moving through the House of Representatives that would repeal a Dodd-Frank mandate that companies compare and disclose the ratio of median employee pay to CEO compensation. So CEOs with big pay packages may rest easy – they might be saved from possible embarrassment in the near future.

So what's the solution?

For a start, directors could align themselves closer to the interests of shareholders. A bad CEO pay package can cost shareholders millions. They have an incentive to make sure that a good CEO is rewarded for strong performance, and a bad CEO is booted without costing them a lot of money. But shareholders are a large, changing group. To directors, they may feel like an abstract concept, especially when the CEO is standing in front of them.

One way to manage rising CEO pay might be introduce compensation caps. High-performing companies like Costco Wholesale and Whole Foods limit the pay of top executives to a multiple of the average worker's pay (in the case of Whole Foods, the cap covered salaries and bonuses, but not stock options). But those limits can be hard to keep, as Whole Foods found out. In the 1980s, the limit started off at eight times the average pay, but was raised to 14 times before the company went public in the early 1990s. When rivals tried to poach Whole Foods' executives, the company increased the multiplier again to 19 times the average worker's pay. This example points to a reality for any board of directors — if you put in place compensation caps, talent may not want to come to your company, and also can be easily lured away.

Another option: Promote CEOs from within a company, rather than making external hires. One study has recently shown that CEOs who came from within their companies outperform those who did not. An internal hire might take the position for less – they may not need the lavish financial promises that other CEO's need to leave their current positions.

None of these options is perfect. But directors need to address this unwarranted rise in CEO pay sooner rather than later. Businesses aren't the only ones who pay when CEO compensation is so out of line with economic realities. We all have a stake in this issue.