A Different Kind of Carrot for our Bosses

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AMERICAN law professor Iman Anabtawi recently wrote that: "Few recent issues have drawn more ire from the public or more bewilderment from scholars than the compensation of public company CEOs". This bewilderment has grown even further thanks to a paper by the University of Sydney's John Shields, published last week in the Australian Journal of Political Economy.

The paper, aptly titled "Setting the double standard: chief executive pay the BCA Way", reports on the increase in pay in the last 15 years of CEOs in 51 ASX-listed public companies that are members of the powerful lobby group, the Business Council of Australia. The findings in the paper are disturbing.

According to Shields, between 1989-90 and 2004-05, average CEO pay in BCA-member companies grew by 564 per cent, and now stands at 63 times average weekly earnings. In 2004-05, the average annual pay (including base salary as well as shares and bonuses) for the CEO of a BCA-member company was $3.42 million.

The BCA's response was that companies need to pay this much in order to attract and retain the best people, who will work to successfully build the company and benefit shareholders through an increased share price and stronger dividends. But Shields's paper disproves the strong link between pay and performance that the BCA and compensation entrepreneurs push.

Perhaps the most significant finding reported by Shields is that since 1999, BCA member CEO pay has increased by roughly 200 per cent, whereas total shareholder return - dividends plus the value of shares (measured by the S&P/ASX accumulation index) - rose by only 60 per cent over this time. Shields writes in his paper that: " in recent years, pay practices that are supposedly contingent on performance have, on average, generated earnings disproportionate to underlying improvements in shareholder value."

What this means is that executive pay practices in Australia are increasingly moving along US lines, where commentators point to a large "decoupling" of pay from performance. In Pay without Performance: The unfulfilled promise of executive compensation (Harvard University Press, 2004), prominent US law professors Lucian Bebchuk and Jesse Fried point out that in their country, between 1991 and 2003 the average CEO remuneration increased from 140 times the pay of an average worker to 500 times average pay.

In a 2005 study, Professor Bebchuk, with his colleague Yaniv Grinstein of Cornell University, also found that from 1993 to 2003, the pay (including salary, bonuses and shares, but excluding

pensions) for the top five executives at the 1500 largest public companies in the US amounted to 9.8 per cent of the profits earned by those companies - double the amount from 1993 to 1995.

What can be done about this trend? While Shields's paper is certainly illuminating, no concrete solutions are put forward as to how pay can be better aligned with performance. It is generally accepted that large pay packets for executives are justifiable if the big pay produces great performance. The common approach worldwide by regulators is to require companies to provide greater disclosure of executive pay arrangements to shareholders.

It is believed (rightly so), that it is inappropriate for regulators to set limits regarding what companies can pay executives, but that (wrongly so) more disclosure will ensure that executive pay is structured with the interests of the company and its shareholders in mind, rather than simply feathering the nest of executives.

Indeed, earlier this month the US Securities and Exchange Commission announced some new proposed rules on disclosure, expected to apply from the 2007 reporting season onwards, which will fundamentally change how executive pay arrangements are disclosed to shareholders.

Australia recently introduced a new rule requiring listed companies to provide shareholders with a report about the company's executive pay arrangements, and shareholders now have the power to have a non-binding vote on these arrangements at the company's annual general meeting.

But it needs to be made clear that disclosure is not the solution to the executive pay problem. As Joseph Nocera recently wrote in the New York Times, in critiquing the SEC's proposed new disclosure rules, "Better disclosure rules are all fine and well, but we already know plenty about executive pay. We know that it is out of control, socially corrosive and divorced from any real rationale".

A lot more is required to resolve the executive pay problem than just enhancing disclosure. Rather, we must let go of the assumption underlying all recent initiatives that pay is necessary to get executives to perform.

In my book, The False Promise of Pay for Performance (Sandstone, 2005), I draw upon an extensive amount of literature from a wide range of areas (including psychology, sociology, and the emerging science of happiness), to explain why the emphasis on "pay for performance" is misguided.

This literature makes it very clear that the overriding motivation of executives in terms of their relationship with the company is not the promise of high salaries and lucrative options packages, but rather the desire to do a good job and be part of a successful and respectable company.

Furthermore, rather than large amounts of money being the key to greater and long-lasting

happiness, studies in the emerging science of happiness suggest otherwise.

It is not money per se that makes people happy, but rather the enhancement of one's "relative position" (that is, being objectively more successful than one's neighbour or colleague) that contributes to our level of happiness and explains our drive for material wealth.

Based on this emerging literature on real human motivation and behaviour, it is time for a fundamental change in our approach to executive pay.

Rather than waiting for the promise of "pay for performance" to deliver, and continuing to focus on improving disclosure requirements for pay arrangements that generally do not work, it is time to embrace a positive model of the company executive. The evidence on executive motivation and the natural competitive instinct of executives can be used in more productive ways.

Adopting this positive approach to corporate governance, the emphasis would be less on being able to say "my bonus is bigger than yours", instead turning to being able to say "my company is more respected/ bigger/ has happier employees/ better products than yours". This is surely better for shareholders and executives.

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