Too Many Turkeys

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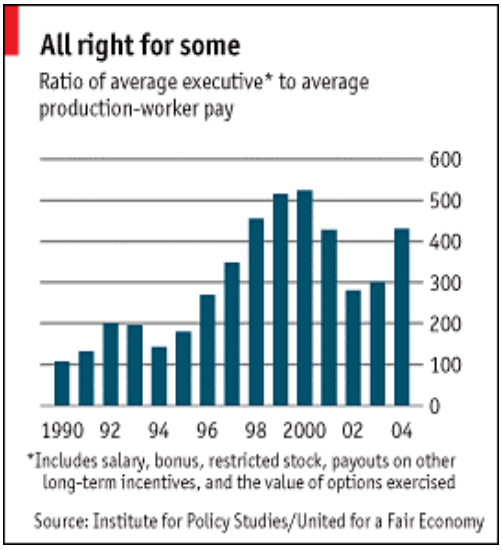
Executive pay is on the rise again—and so are complaints that ordinary performance is attracting extraordinary rewards

AMERICA'S top executives had plenty to celebrate as they tucked into their turkey this Thanksgiving—a resurgent stockmarket, record profits and, above all, their own ever-expanding pay packets. In the years immediately after the bursting of the dotcom bubble and the scandals at Enron and the like, executive pay fell—at least by some measures. But that, it is now clear, was but a blip, mostly reflecting managers' reluctance to cash in share options in what was then an unattractive stockmarket.

Executive compensation in America—already far ahead of the rest of the world, despite the best efforts of overseas managers to catch up—is now rising inexorably again. In fiscal year 2004 the total compensation of the median American company boss rose in every industry, by between 9.7% in commercial banking and 46.1% in energy, according to a new report by the Conference Board, a research organisation. In the big companies that comprise the S&P 500 index, median total chief-executive compensation increased by 30.2% last year, to $6m, compared with a 15% rise in 2003, according to a study published last month by the Corporate Library, a firm that tracks corporate-governance data.

Recent higher profits are part of the explanation for higher pay. But there is a longer-term trend at work. In 2004 the ratio of chief executives' compensation to the pay of the average production worker jumped to 431 to one from 301 to one in 2003, according to "Executive Excess", a recent study of 367 big American firms by the left-leaning Institute for Policy Studies. That is not quite a record: in 2000 the ratio reached 525 to one (see chart). In 1990 the ratio was 107 to one and in 1982 a mere 42 to one. This year's numbers seem certain to show the gap widening still further.

But while unionists and left-leaning politicians are worried about social equity, investors typically have a different sort of concern. They are happy to pay for exceptional performance; but less delighted when mediocre managers get lavishly rewarded. The contrasting cases of James Kilts and Michael Eisner make the point.



Mr Kilts, the boss of Gillette, has publicly accused critics of the $165m bonus he got for selling his firm to Procter & Gamble for $53 billion of "unsubstantiated, inaccurate and irresponsible criticism" and of treating him like a "piñata"—a sweet container that American children bash at parties. Piñata Jim may have a point. He did a lot to restructure Gillette—allowing it to be sold for a fancy price, to the huge benefit of its shareholders. It is when vast payments are the reward for poor performance that it is time to cry foul. Michael Eisner was an outstanding manager during the first part of his more than 20 years at the top of the Walt Disney Corporation. But as Leo Hindery points out in a new book ("It Takes a CEO"), he was also paid $800m over

a 13-year period during which the company's shareholders would have done better by investing in Treasury bonds.

The populist end of the debate has led to some action in Congress. Barney Frank, a left-wing Democrat, has just introduced legislation intended to tackle the “problem of runaway executive compensation”. Wisely, he is mostly seeking to improve disclosure, rather than actually to cap pay at a specific level, which experience suggests would encourage creative ways around the cap.

A 1994 reform that limited tax deductibility of executive pay to $1m merely turned the $1m maximum into the *de facto* norm, and inspired the rapid growth of share options as an alternative form of tax-favoured compensation. Some experts now blame the peculiar risk-taking incentives created by share options for many subsequent corporate scandals. Although Mr Frank's legislation is not expected to become law, it is adding to the pressure on the Securities and Exchange Commission to make better use of its powers to demand full disclosure.

Even some businessmen are now calling for restraint. Edgar Wollard, a former boss of DuPont, recently proposed that a chief executive's compensation should be indexed to the pay of the senior vice-presidents that head his firm's divisions. At DuPont, he was limited to 150% of the average pay of those other top executives. Mr Hindery, a serial CEO in the telecoms and media businesses, says he has published his book partly because greed in corporate America is now damaging capitalism.

Many experts see the continuing rise of executive compensation—and the continuing lack of a demonstrable link to performance—as a symptom of a massive failure of corporate governance. Greater pressure from shareholders is generally regarded as the only real antidote. But critics of perceived executive excess have been frustrated by shareholder passivity, which is sometimes blamed on the short time horizons of many investors.

So is there a cure? Certainly, fuller disclosure would help, argues Lucian Bebchuk of Harvard Law School and co-author of a recent book, “Pay Without Performance: The Unfulfilled Promise of Executive Compensation”. If there were proper disclosure of forms of executive pay such as pensions, supplementary pensions and deferred compensation, then it would be easier for shareholders to see whether chief executives are being rewarded for genuinely good work.

It is the issue of aligning incentives and rewards—rather than the absolute level of pay—that tends to concern professional investors most. “There is no right or wrong number”, says Bob Pozen, chairman of MFS Investment Management, which has $160 billion under management. It is hard to judge the merits of a package without looking carefully at the details, he says, which is why he has little time for Mr Frank's proposal for shareholders to vote each year on the executive compensation package. In Britain, where shareholders now get a non-binding vote on compensation, it has had no real impact, he reckons.

Blame the consultants

Mr Pozen reserves his fiercest ire for the kind of executive pay package that rewards bosses generously even if they fail. And he is extremely critical of the role of compensation consultants. They, he says, tend to be chosen by the chief executive, and to drive up pay by recommending that the top man should be paid more than his peers, having chosen a group of peers whose pay errs on the high side.

Ira Kay, an executive-compensation consultant at Watson Wyatt, strongly disagrees, pointing out that the compensation committee of the board increasingly hires the consultant—a change he regards as “revolutionary”. Moreover, in the past few years many American firms have changed their approach to executive pay, he says, improving disclosure and changing the composition of pay packages so that they provide stronger incentives to manage for the long run. In particular, share-option grants have fallen sharply, while there are more grants of restricted stock (that pay out only over time or when a performance target is hit).

Even so, a survey Mr Kay is working on suggests that there is now as “large a gap as I have seen between what institutional investors and boards think about executive compensation”. Boards think they are doing a good, shareholder-friendly job; institutional investors do not. Mr Kay fears that if the institutions do grow more militant about executive pay, there is a “risk of a return to the 1970s”, with bosses paid like bureaucrats and talented managers seeking more rewarding work elsewhere.

That would indeed be a bad thing. But judging by recent trends—and the continuing failure to reform board elections to make it easy for shareholders to vote out directors who are too friendly to management—hell is more likely to freeze than bosses' pay.