Money Can't By You…Performance

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By James McConvill
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A fresh look at what motivates executives is overdue, writes James McConvill.

Recent research by institutional adviser Proxy Australia shows that Australian chief executives are enjoying windfall gains on their stock options, far above the value disclosed to shareholders. The study has prompted shareholder calls for greater disclosure of executive remuneration arrangements, including disclosing option gains and valuation methods.

Internationally, executive remuneration has become the most contentious aspect of contemporary corporate governance. As US legal scholar Ima Anabtawi recently wrote: "Few recent issues have drawn more ire from the public or more bewilderment from scholars than the compensation of public company CEOs." What has been of particular concern is the "decoupling" of executive pay from company performance. That is, CEO remuneration continues to skyrocket even as the companies they manage enjoy modest growth, no growth, or negative growth.

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 the US between 1991 and 2003 the average large-company CEO's total remuneration increased from 140 times the pay of an average worker to 500 times average pay. Similarly, in Australia between 1992 and 2002 CEO remuneration increased from about 22 times average weekly earnings to 74 times average earnings.

Bebchuk and Fried's book has produced a lot of debate about executive compensation, particularly in relation to the "managerial power" thesis the authors put forward to explain the decoupling of pay from performance that we have witnessed. Under their "managerial power" thesis, senior executives are considered to be overwhelmingly motivated and guided by self-interest, with their self-interest directly connected to their pay. These self-interested executives are considered to have enormous influence over the boards of directors that determine executive pay (principally due to having a say over which directors the companies will nominate for re-appointment), and that as a consequence structure remuneration arrangements with the interests of the CEO as the primary concern.

Bebchuk and Fried do not in any way question the legitimacy of using "pay for performance" as the principal methodology for determining executive pay, and indeed contend that appealing to the hip pocket of executives is the best way to motivate them to perform and to satisfy their personal objectives. Pay executives as much as they can dream of, they contend, so long as there is a demonstrable correlation between higher pay and better company performance.

In a new book, *The False Promise of Pay for Performance: Embracing a Positive Model of the Company Executive*, to be released next month by Sandstone Academic Press, I directly respond

to the "managerial power" thesis outlined by Bebchuk and Fried in *Pay Without Performance*, and in particular the negative model of the company executive that they put forward.

A wide range of literature (including from psychology, sociology, and the emerging science of happiness), helps explain why the emphasis on remuneration and "pay for performance" is misguided. This literature makes it 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 good and be part of a successful and respectable company. Furthermore, rather than more and more money being the key to greater happiness, studies in the 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), which comes from a high income and a luxurious lifestyle that contributes to our level of happiness and explains our drive for material wealth.

Based on the evidence of this emerging literature, it is time for a fundamental change in our approach to executive remuneration. Rather than waiting for "pay for performance" to deliver and focusing on improving disclosure requirements for remuneration 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.

The emphasis in this positive model of executive behaviour is less on being able to say "my options are bigger than yours", than on 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.