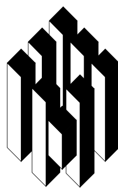

C.D. Howe Institute
Institut C.D. Howe

Communiqué

Embargo: For release *Thursday*, September 12, 1996

Pros and cons of generous pay packages for senior executives subject of new C.D. Howe Institute study

Senior executives' pay packages have climbed faster than average incomes over the past 15 years, but highly publicized and controversial lists of the "ten best paid" executives merely represent extreme examples, cautions a study released today by the C.D. Howe Institute. Moreover, the study says, remuneration of senior Canadian executives is only about 65 percent of that of their US counterparts.

The study, entitled *Value for Money: Executive Compensation in the 1990s*, was written by Edward Iacobucci, a recent graduate of the Faculty of Law at the University of Toronto, and is the outgrowth of a roundtable held in December 1995 and sponsored by the C.D. Howe Institute, the Ontario Securities Commission, and the Law and Economics Programme at the University of Toronto.

Iacobucci points out that there may be good reasons to pay senior executives generously. "If the prize at the top is sufficiently enticing," he says, "lower-level employees will compete for promotion, providing the firm with more productive labor at lower levels at lower costs." Furthermore, generous compensation packages are often based on, and reflect, drastically improved corporate performance.

Iacobucci reviews the various methods of corporate remuneration and concludes that compensation packages can be an important incentive to senior management to act in the best interests of the shareholders. However, he also warns against a "one size fits all" strategy, pointing out that "compensation is potentially very important to the health of a company, but no simple formula can capture the optimum arrangement in every situation."

At the same time, Iacobucci is critical of the way in which executive compensation is set, noting that it "is rife with potential conflicts of interest and inherently flawed because of the divergence in economic interests between the executives, who are directly concerned with compensation, and directors, whose interest is attenuated." He points to the pressures that can be brought to bear on compensation committees and the widespread practice of having the

chief executive officer (CEO) serve as chairman of the board — the same board that sets pay policies for senior executives.

To address these concerns, Iacobucci suggests basing directors' fees on equity, not cash, so that the interests of board members will lie in improved corporate performance; making compensation committees independent from the management of the firm; and prohibiting a CEO from serving as chairman of the board.

Iacobucci closes his paper by warning that "simplistic conclusions about executive compensation are unlikely to advance the debate; it is far too complex for black-and-white thinking."

The volume also includes a number of comments on Iacobucci's paper by academics and senior executives, who address the questions: Is there a problem with executive compensation? If there is a problem, what are its causes? If there is a problem and if its causes can be identified, what policy responses are appropriate? In closing remarks, C.D. Howe Institute President Thomas E. Kierans picks up on the difficulty of "one size fits all" solutions and points out that these are "[corporate] governance issues; they are not for the regulator."

* * * * *

The C.D. Howe Institute is Canada's leading independent, nonpartisan, nonprofit economic policy research institution. Its individual and corporate members are drawn from business, labor, agriculture, universities, and the professions.

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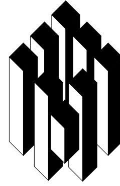

C.D. Howe Institute
Institut C.D. Howe

Communiqué

Embargo: à diffuser *jeudi,* le 12 septembre 1996

Les avantages et les inconvénients de la compensation généreuse des cadres supérieurs font l'objet d'une nouvelle étude de l'Institut C.D. Howe

La rémunération des cadres supérieurs a augmenté plus rapidement que les revenus moyens des 15 dernières années, toutefois les listes rendues publiques et prêtant à controverse des « dix cadres supérieurs les mieux rémunérés » ne représentent que des cas extrêmes, prévient une étude publiée aujourd'hui par l'Institut C.D. Howe. De plus, indique l'étude, le niveau de rémunération des cadres supérieurs canadiens n'atteint que 65 pour cent de celui de leurs collègues américains.

L'étude, intitulée *Value for Money: Executive Compensation in the 1990s (En avoir pour son argent : la rémunération des cadres des années 90)* est rédigée par Edward Iacobucci, récemment diplômé de la faculté de Droit à l'université de Toronto; elle fait suite à une table ronde qui a eu lieu en décembre 1995, subventionnée par l'Institut C.D. Howe, la Commission des valeurs mobilières de l'Ontario et le programme de droit et d'économie de l'Université de Toronto.

Iacobucci indique qu'il y a de bonnes raisons de bien payer les cadres supérieurs. « Si le prix en haut de l'échelle est suffisamment attirant, indique-t-il, les employés aux niveaux plus bas se feront concurrence pour être promus, fournissant à l'entreprise une main-d'œuvre plus productive à des niveaux plus bas et à des coûts moindres ». De plus, les rémunérations généreuses se fondent souvent sur un rendement d'entreprise considérablement amélioré et reflètent celui-ci.

Iacobucci passe en revue les diverses méthodes de rémunération des cadres et conclut que les régimes de rémunération constituent une incitation importante pour que les cadres supérieurs agissent dans l'intérêt des actionnaires. Toutefois, il avertit contre une stratégie unitaille, en indiquant que la « rémunération est éventuellement très importante pour la santé d'une entreprise, mais il n'existe pas de simple formule qui offre un mécanisme idéal pour toutes les situations. »

Dans un même temps, Iacobucci critique la façon dont on établit la rémunération des cadres, en faisant la remarque suivante : « elle est truffée d'éventuels conflits d'intérêts et de défauts inhérents à cause de la divergence des intérêts économiques entre les cadres, qui sont directement préoccupés par la rémunération et les directeurs, dont l'intérêt est autre ». Il souligne les pressions qui peuvent être exercées sur les comités de rémunération et la pratique

généralisée de demander au président-directeur général d'être également président du conseil d'administration — le même conseil qui établit les politiques de paie pour les cadres supérieurs.

Pour résoudre ces problèmes, Iacobucci propose que l'on détermine les allocations des membres du conseil en fonction de l'avoir des actionnaires et non en espèces, afin que leurs intérêts reposent sur un rendement d'entreprise amélioré; que l'on rende les comités de rémunération indépendants de la gestion de l'entreprise; et que l'on interdise à un président-directeur général d'être président du conseil d'administration.

Iacobucci conclut son document en avertissant que « les conclusions simplistes sur la rémunération des cadres ne sont pas susceptibles de faire progresser le débat; il est bien trop complexe pour un raisonnement non nuancé ».

Le document comporte également plusieurs commentaires émis par des universitaires et des cadres supérieurs, qui portent sur ces questions : la rémunération des cadres pose-t-elle un problème ? S'il y a en fait un problème, quelles en sont les causes ? S'il y a un problème et que ses causes peuvent être cernées, quelles sont les réponses les plus appropriées en matière de politique ? Dans le cadre de ses observations finales, le président de l'Institut C.D. Howe, Thomas E. Kierans, reprend la difficulté d'une solution « unitaille » et indique qu'il s'agit de « questions de gouvernement d'entreprise; elle ne relèvent pas d'un organisme de réglementation ».

* * * * *

L'Institut C.D. Howe est un organisme indépendant, non-partisan et à but non lucratif, qui joue un rôle prépondérant au Canada en matière de recherche sur la politique économique. Ses membres, individuels et sociétaires, proviennent du milieu des affaires, syndical, agricole, universitaire et professionnel.

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The Law and Economics of Executive Compensation

Edward Iacobucci

with Michael J. Trebilcock

In 1982, *Fortune* magazine published an article, provocatively entitled "The Madness of Executive Compensation," that noted the high salaries and bonuses of various corporate executives in the United States, including Rand Araskog, chairman of ITT, who had received compensation of $1.15 million in 1981 (Loomis 1982, 42). If this amount constituted "madness," one would be hard pressed to describe the compensation of that country's chief executive officers (CEOs) and other top executives less than a decade later. *Business Week* (Byrne 1991, 90) reports that, in 1986, Lee Iacocca of Chrysler earned a then-unprecedented compensation package of $20.5 million; a year later, Charles Lazarus, chairman of Toys 'R' Us, took home more than $60 million; in 1988, Michael Eisner of Disney earned $40.1 million for his efforts; and in 1990, Time Warner's Steven J. Ross realized $78.2 million and Donald Pels, the chief executive of LIN Broadcasting, earned $186.2 million. Finally, in 1993, Disney rewarded Eisner with the sum of $203.0 million (Hardy 1994, 141).

Canadian executives generally lag behind their colleagues to the south in compensation, but several are doing very well. In 1991, Peter Munk, chairman of American Barrick Resources, reaped a then-unprecedented $32.3 million, but this record was broken in 1993 by Frank Stronach's pay package of almost $41 million, earned as chairman of Magna International (Pritchard 1994, B1).

These staggering figures have created a great deal of controversy and inspired diametrically opposed opinions. Compare the

titles of two well-known commentaries on executive compensation: "Top Executives Are Worth Every Nickel They Get" (Murphy 1986), and *In Search of Excess: The Overcompensation of American Executives* (Crystal 1991b). This paper sketches the contours of the debate, primarily by means of a literature review.

I begin by outlining the economic theory of compensation for labor and the basic reasons behind various executive compensation schemes. Then, I present the empirical evidence on compensation, outline the legal framework for establishing executive compensation packages, and explain how this framework could lead to inappropriate compensation schemes. Finally, I survey proposed reforms to the existing compensation decision process and suggest some areas for further study.

The Economics of Executive Compensation

In a perfectly competitive labor market, say the economists, each worker is willing to work for a wage no lower than he could obtain in alternative employment. Each employer, on the other hand, pays whatever wage is necessary to hire an additional worker so long as hiring him is profitable. As a result, the worker is paid his value to the firm: the value of the marginal product of his labor.[1] If this theoretical process accurately described what happens in the market for executives, there should be little controversy over their pay. Each would receive the value of his marginal product. This story, however, is far too simplistic to describe compensation in the executive labor market; it does not reflect the divergence of interests between the owners of a corporation and the managers who control it. Because of this divergence, how executives are paid influences their marginal products (see Jensen and Murphy 1990a). Compensation itself alters productivity.

1 For more elaboration on the theory of the determination of wages, see Gunderson (1993).

The Separation of Ownership and Control

In most major corporations in today's economy, shareholders are the firm's owners, but rarely are they its managers. This split has long been recognized as creating an inefficient divergence between the owners' and the managers' motivations. While owners are said to care only about profit, managers may not face the proper incentives to maximize it. Indeed, this potential for inefficiency was noted by Adam Smith:

> The directors of such [joint-stock] companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartner frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honor, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company. ([1776] 1937, 700.)

In the first half of this century, Berle and Means explored the economic implications of the trend toward increased public ownership of corporations. They were pessimistic:

> Though the American law makes no distinction between the private corporation and the quasi-public, the economics of the two are essentially different. The separation of ownership from control produces a condition where the interests of owner and ultimate manager may, and often do, diverge....Those who control the destinies of the typical modern corporation own so insignificant a fraction of the company's stock that the returns from running the corporation profitably accrue to them in only a very minor degree. The stockholders, on the other hand, to whom the profits of the corporation go, cannot be motivated by those profits to a more efficient use of the property, since they have surrendered all disposition of it to those in control of the enterprise. The explosion of the atom of property destroys the basis of the old assumption that the quest for profits will spur the owner of industrial property to its effective use. (1933, 7–9.)

More recently, Jensen and Meckling have examined the implications of the separation of ownership and control for a firm's optimal capital structure. As a preliminary observation, they note:

> While the literature of economics is replete with references to the "theory of the firm", the material generally subsumed under that heading is not a theory of the firm, but actually a theory of markets in which firms are important actors. The firm is a "black box" operated so as to meet the relevant marginal conditions with respect to inputs and outputs, thereby maximizing profits, or more accurately, present value. Except for a few recent and tentative steps, however, we have no theory which explains how the conflicting objectives of the individual participants are brought into equilibrium so as to yield this result. (1976, 306–307.)

Focusing on the implications for the motivation of managers of owning a smaller proportion of the firm's capital, Jensen and Meckling note that one result is significant agency costs, which they define as the costs a principal faces as a consequence of suboptimal behavior associated with outside capital. As the proportion of equity held by the manager falls, so does the cost *to her* of indulging in suboptimal activities, such as illicit perquisite consumption. The authors conclude that outside share ownership increases these agency costs.[2] In contrast, as Fama notes, when the manager is the firm's sole security holder,

> there is clearly no incentive problem. When he is sole security holder, a manager consumes on the job, through shirking, perquisites, or incompetence, to the point where these yield marginal expected utility equal to that provided by an additional dollar of wealth usable for consumption or investment outside of the firm. (1980, 295.)

Various institutions are identified as providing discipline for corporate managers. As Trebilcock summarizes:

2 For further exploration of this theme, see Fama (1980); and Fama and Jensen (1983).

> The recent literature identifies three main factors that help align the interests of principals and agents in publicly traded corporations: the market for managers, the output market and the market for corporate control. First, competition in the market among and for managers encourages greater efficiency, greater innovation, and lower agency costs. Second, competition among firms in their output markets requires firms to act efficiently if they are to survive and if managers are to retain their jobs. Third, private capital markets where firms must raise equity or debt capital will discipline weak management....In addition, where a firm's shares are traded on the stock market, corporate takeovers are possible whenever a company is being poorly managed. (1994, 9–10.)

Agency Costs

Although these institutions are indeed significant in controlling agency costs, a manager's compensation scheme may also serve as a control. Before considering this potential role of compensation schemes, it is useful to outline the types of agency problems that may arise. They can be grouped under two broad headings: overconsumption of perquisites, and suboptimal choices about risk.

Perquisites

Perquisite overconsumption can take a variety of forms. An executive may use the firm's resources for his own private benefit by endowing himself with items such as lavish office furniture or private jets. Some of the most notorious examples of this form of agency cost were provided by the executives at RJR Nabisco before its takeover by Kohlberg, Kravis and Roberts. Consider the following description of executive headquarters:

> The reception area's backdrop was an eighteenth-century $100,000 lacquered Chinese screen, complemented by a $16,000 pair of powder blue Chinese vases from a slightly later dynasty. Visitors could settle into a set of French Empire mahogany chairs ($30,000) and ogle the two matching *bibliothèque* cabinets ($30,000) from the same period. In each was an English porcelain dessert service in a tobacco-leaf pattern ($20,000). (Burroughs and Helyar 1990, 93.)

Perquisite overconsumption may also take the form of enjoying too much leisure time or of empire building. Rather than providing full effort, an executive may prefer to shirk on the job, providing herself with a good, leisure, but depriving the firm of value. A potentially devastating incentive is the pleasure an executive may derive from becoming a "captain of industry" at the helm of a mighty conglomerate, which may lead to the costly, inefficient acquisition of other firms.

To illustrate how such agency costs are aggravated by increasing outside capital, consider the following simple numerical example. Suppose an hour of shirking brings the executive a private benefit of $3.00, but reduces his productivity to the firm by $4.00. If the manager is the firm's sole owner, shirking will cost him $4.00 but will bring him only a $3.00 benefit, so he will not shirk. If, however, he owns only half the firm, shirking will personally cost him only $2.00, so he may shirk.

Risk

A second type of agency cost concerns risk. Shareholders diversify their portfolios so as to minimize risk to themselves. Consequently, they are approximately risk neutral with respect to the actions of a particular firm. No matter what the riskiness (variance) of the payoffs from a particular course of action, shareholders prefer that managers pursue projects with the highest expected values. Managers, however, may not be risk neutral with respect to investment decisions. For example, since their reputations in the managerial labor market are affected by the outcome of the investment decisions they make and since they are unable to diversify their investment in reputation, they will likely display some risk aversion in making these decisions. As a result, they may pursue not profit-maximizing courses of action but rather courses that maximize their personal utility, which may not include risky ventures.[3]

3 For a seminal discussion of the effects of risk aversion on incentive schemes, see Holmstrom (1979).

For an illustration of this agency cost, consider another simple numerical example. The manager faces a choice between two investments. Investment A has a guaranteed profit of $1.00 to the firm, which will preserve the manager's reputation for sound investment. Investment B has a 50 percent chance of utter failure and a profit of nil, and a 50 percent chance of success and a profit of $3.00. If the project fails, the manager's reputation will be significantly harmed, thus lowering her expected future wages, but if the project pays off, her reputation will be enhanced, thus increasing her future expected wages. Shareholders, being risk neutral, prefer investment B, which has an expected profit of $1.50, to investment A, with an expected payoff of only $1.00. A risk-averse manager, however, may choose investment A, which guarantees the preservation of her reputation, rather than investment B, which puts her reputation at risk.

Risk aversion may thus lead to further agency costs as the result of the separation of ownership and control.

Executive Compensation and Agency Costs

If shareholders and executives could enter into fully contingent claims contracts, agency costs could be eliminated by contract. That is, as Jensen and Murphy say,

> [i]f shareholders had complete information regarding the CEO's activities and the firm's investment opportunities, they could design a contract specifying and enforcing the managerial action to be taken in each state of the world. (1990b, 226.)

In this case, agency costs would be eliminated simply by penalizing the CEO for breaching this complete contract.

Of course, such a suggestion is hardly practical. As the authors continue,

> [m]anagerial actions and investment opportunities are not, however, perfectly observable by shareholders; indeed, shareholders

> do not often know what actions the CEO *can* take or which of these actions will increase shareholder wealth. (Ibid.)

This is not to say that contractual arrangements are unable to address these problems. Although it would be impractical to incorporate explicit instructions about perks and risks in an executive's contract, such a contract can include incentives that make it in the executive's best interests to promote the owners' goal of profit maximization. Properly framed compensation arrangements may better motivate an executive, reducing agency costs. As Lambert and Larcker put it:

> "[A]gency theory" has focused attention on the separation of ownership from control in large public corporations. In the context of this theory, management incentive compensation plans are viewed as one of several important means of reducing potential conflicts of interest between management and shareholders....To the extent that the separation of ownership from control is a serious problem in the large public corporation..., an effective compensation program can add value to the firm by improving the alignment of management incentives with stockholder interests. (1991, 100.)

In the numerical examples above, the agency costs resulted because the private benefit to the executive from engaging in suboptimal activity was greater than the private cost, even though the social benefit of optimal behavior was greater than the social cost. A properly framed compensation contract can lower the private benefit of engaging in a particular undesirable activity, increase the private benefit of engaging in desirable activities, and/or increase the cost to the executive of engaging in suboptimal behavior.

The following discussion outlines the basic forms of executive compensation[4] and the type of agency cost each scheme may address.[5]

---

4 The forms of compensation considered here are those outlined in Milgrom and Roberts (1992, 425).

5 To focus the discussion on the effect of compensation schemes, I assume throughout that outside discipline on managerial behavior — such as an executive's desire to protect his reputation in the managerial labor market — is of trivial importance; the executive's incentives depend on the compensation scheme.

Bonuses

Milgrom and Roberts define a ***bonus*** as

> [a] nominally variable amount, often paid as a lump sum, at the discretion of the firm's directors. May be tied to performance either implicitly or through an explicit formula. If so, performance is usually measured on a short-term basis, such as the previous year's accounting profits or earnings growth, or the extent to which these exceed targets. (1992, 425.)

The implicit or explicit promise of a bonus for observed levels of his firm's performance provides the executive with a private incentive to ensure that it performs well. Consider the simple numerical example of the executive to whom the cost of working an additional hour was $3.00, but the benefit to the firm was $4.00. If his pay is constructed so that he receives a bonus of $3.50 for generating an extra $4.00, he will not shirk and there is a Pareto improvement over the no-bonus situation: the executive is better off by $0.50 ($3.50 bonus less $3.00 cost of effort) and the firm is also better off by $0.50 ($4.00 worth of effort less $3.50 bonus). Bonuses thus attenuate the agency cost of shirking (or, more generally, perquisite consumption).

Firms use a variety of types of bonus systems. A common mechanism is to reward executives by paying them a bonus whose size depends on the firm's return on equity (ROE). This relationship may be linear (for every percentage point that the ROE increases, the executive's pay increases) or nonlinear (for every percentage point above a certain minimum ROE, the executive's pay increases).

The latter system was the one implemented by Disney when it hired Michael Eisner. Crystal (1991a, 353–355) reports that, at the time (1984), Disney was a mediocre performer, earning about a 9 percent ROE. Eisner's compensation package for each of the six years of the contract included a base salary of $750,000 (which was low for a CEO in the major entertainment industry) and an annual bonus equal to 2 percent of all after-tax profits in excess of a 9 percent ROE. Disney's performance improved dramatically. In 1983, its profit

was in the $100 million range; by 1988, it had risen to $550 million. The stock price was about $14 a share when Eisner joined the firm; by 1988, it had risen to $66. Eisner's compensation reflected this growth in prosperity, with his annual bonus reaching the $7 million level. On its face, the compensation package offered Eisner appears to have provided him with incentives that were desirable from a shareholder perspective; Crystal estimates that Disney's performance outstripped by around $5 billion what the author deems appropriate expectations for growth in shareholder wealth.

Other measures for determining executives' annual bonus include annual profit (either before tax or net of tax), earnings per share, and growth in earnings per share. In all these cases, the bonus is usually based on the amount by which the firm's performance exceeds a specified level of the chosen statistic.

Drawbacks. Bonuses may be valuable tools in the hands of the principals (the shareholders) to induce desirable activity from their agents (the executives). They may, however, also have significant drawbacks both for shareholders and for executives.

First, they may induce incorrect incentives with respect to the horizon of executive decisionmaking. Shareholder (and societal) value is maximized by choosing investments that have a positive net present value to the firm. If, however, the profit from a particular project is in the relatively distant future, an executive whose discount rate is higher than that of the firm (perhaps because her retirement is imminent) may choose to pursue alternative projects with expected profit that is low overall, but high in the immediate future. Bonuses thus may encourage executive myopia. As Burchman says:

> [A]nnual earnings do not capture the future impact of current decisions on earnings. For example, while major investments in advertising and research and development may have an immediate depressing effect on earnings, they may have a significant long-term positive effect on future earnings. (1991, 197.)

Second, earnings measures may not accurately reflect the performance of the executive herself but exogenous factors that are internal or external to the firm. Internally, there is little doubt that, although a CEO is an important determinant of a firm's performance, its other employees can have a critical effect on profit. For example, a breakthrough (or setback) in research and development may significantly affect earnings, and therefore executive pay, with little connection to executive performance. Externally, poor or admirable firm performance may depend on industry trends that are also unconnected to executive performance. No matter how diligent the CEO, an increase in the cost of inputs resulting from, say, a natural disaster will reduce profit.

The imperfect correlation between executive effort and firm performance results in unwanted risk to the managers, who, unlike shareholders, are unable to diversify their earnings "portfolio." As Daniels puts it:

> Because the value of managerial performance is not perfectly observable, shareholders must rely on proxy measurements.... In some cases, however, these measurements, while bearing rough correspondence to managerial effort, incorporate factors that are beyond the control of managers. This, in turn, imposes non-diversifiable risks on managers. (1994, 43.)

This risk has essentially two related costs, as Lambert and Larcker point out:

> First, an increase in management's exposure to risk will make the compensation scheme less attractive, all other things being equal; and in return for bearing additional risk, executives collectively will require an increase in the general level of their compensation. Second, increasing an executive's exposure to risk may cause him to become more conservative in his investment strategy. An executive may turn down risky projects and accept only "safe" projects offering sizable, but substandard returns. (1991, 103.)

The advantages of portfolio diversification, which allows shareholders to be risk neutral with respect to the performance of a particular firm, are undermined if the manager of each firm is risk averse and faces risk in his compensation package. Rather than choosing projects that maximize expected profit, managers may choose investments with smaller but more certain returns.

Risk Reduction. Comparative performance measures may usefully reduce the risk a manager faces from industry trends. If the industry has slumped generally, a relative performance measure captures that effect, and the manager is not necessarily penalized personally for an industry trend. In contrast, poor performance relative to other firms in the industry is likely related to firm-specific factors, and the manager is appropriately penalized. As Lambert and Larcker say:

> In such *relative* performance schemes, executive compensation is set according to how well the company performs relative to a comparison or peer group. The implicit assumption underlying this approach is that the construction of a peer group allows general market or macroeconomic influences and industry-specific influences to be removed from the performance measure, thereby providing a better measure of an executive's distinctive contribution to the firm's profitability. (Ibid., 104.)

As Holmstrom (1979) shows, the increased accuracy of a performance proxy reduces the risk facing managers, which, in turn, allows the firm to lower the level of compensation while leaving managers' utility unchanged. Furthermore, the cost of risk-averse decisionmaking on the part of executives is reduced.

Summary. In sum, bonuses provide executives with incentives that can control agency costs, but they have disadvantages such as encouraging managerial myopia and increasing managerial risk. This risk may be reduced, however, by basing the bonus on relative measures, rather than strictly on firm-specific measures.

Salaries

Milgrom and Roberts define *salary* as

> [a]n amount paid over the course of the year and fixed in advance. Salary may be adjusted regularly based on length of service, competitive conditions, the cost of living, performance, or other considerations. (1992, 425.)

Unlike a bonus, an annual salary is not contingent on the firm's performance for that year. Its central advantage to both the manager and the firm's owners is its risk-reducing qualities. Since the salary is fixed, the manager's actions have no immediate impact on his remuneration. The desirable effects are twofold. First, with the cost of risk to the manager reduced, his level of compensation may be lower than in a riskier pay structure yet leave him just as well off. Thus, the amount of compensation is generally lower if paid as salary than if paid as a bonus, which, *ceteris paribus*, leaves the manager equally well off and the shareholders better off. As Milgrom and Roberts state:

> If the firm can be treated as risk neutral (perhaps because it is owned by investors with well-diversified portfolios), then, other things being equal, it should seek to insulate the workers fully against income risk. This provides a value-creating service for the employees while imposing no cost or risk premium on the risk-neutral firm. The expected pay level can be reduced without harming the workers if the firm takes on some of the risk they would otherwise face, and so both sides can gain. (1992, 333.)

A second effect of the risk-reducing qualities of a fixed salary is the corresponding reduction in the risk aversion of managers in choosing investment opportunities. Recall the example in which the manager must choose investment A with a guaranteed payoff of $1.00, or investment B with a 50 percent chance of no payoff and a 50 percent chance of a payoff of $3.00. If remuneration depends on the payoff from the investment, a risk-averse manager is more likely to choose the guaranteed return offered by investment A, contrary to the wishes of shareholders. If, however, she is secure in receiving

her salary regardless of the outcome of the investment, she is more likely to choose the profit-maximizing course of investment B. A salary thus serves to mitigate the agency costs associated with risk-averse managers.

Drawbacks. The disadvantages of a fixed salary reflect the principal-agent problems already discussed. Since a manager on fixed salary faces no gain or loss from either providing optimal effort or engaging in suboptimal activities such as perquisite consumption, the likelihood of the latter increases. An executive who is paid strictly by salary is more likely to shirk and to consume other perks rather than to engage in utility-reducing hard work. In other words, although a fixed salary may induce an executive to take a lower salary to engage in riskier investments, it provides little in the way of incentive to add value to the firm. The insurance-enhancing properties of a salary must be balanced against its inability to control moral hazard.

Summary. In sum, tension exists between bonus and salary as tools for compensation. A bonus helps align executive and shareholder interests with respect to perquisite consumption but exposes the manager to unwanted risk; a fixed salary, on the other hand, insulates the executive from risk but fails to discourage moral hazard. As Milgrom and Roberts say, the goals of compensation policy "may not be consistent. For example,...providing motivation may require basing pay on performance. However, this may prevent realizing the gains that would come from insulating employees against income risk" (ibid., 390).

Stock Awards

Milgrom and Roberts define *stock awards* as

> [s]hares in the firm given to the executive or sold to him or her at a deep discount. Often the ability of the executive to sell this stock is restricted, at least until certain conditions are met. (Ibid., 425.)

The main strength of this form of compensation, it is said, is that it aligns the interests of the executive with those of the shareholders. Any increase in the value of the stock will lead to an increase in the executive's private wealth, thereby inducing him to maximize shareholder wealth. As Buyniski states:

> Perhaps the prime reason why stock compensation is still appropriate is that none of the alternatives provide the same or similar benefits in an efficient manner. Specifically, nonstock vehicles cannot directly tie executive returns to shareholder wealth. (1991, 306.)

Or as Milgrom and Roberts put it:

> [A]ssuming that the market value of the firm at any point reflects the best estimate of the future cash flows that the firm will generate, market-value maximization is again the proper test of performance. Tying the CEO's pay to the value of the firm would direct attention exactly where it belongs. (1992, 437.)

Drawbacks. The drawback of stock grants is similar to the problem with bonuses: although they help to align the interests of managers and shareholders with respect to value maximization, they are risky for the executive. Undertaking a successful project may increase the value of the shares and thus increase the executive's compensation, but undertaking a failed project may lower it. A privately risk-averse manager may therefore choose investments that are safe rather than those that are value maximizing. Stock awards thus provide incentives for value maximization that may be attenuated by managerial risk aversion.

Stock Options

As defined by Milgrom and Roberts, *stock options* are

> [r]ights given to the executive to buy stock in the firm at a prespecified price during a specific period of time. The price is usually at or above the current price of the stock when the

> options are awarded, and the time period is usually several years. No actual cash is received until the executive actually buys the stock. Then the compensation is the difference between the market price of the stock and the exercise price (the amount paid by the executive). (Ibid., 425.)

This form of compensation is the most frequently used of the various stock compensation schemes; in 1987, 81 percent of companies in the United States that used stock compensation used options (Buyniski 1991, 291).

The popularity of options has a variety of reasons. First, they accomplish the basic task of aligning manager and shareholder interests. For an executive to reap any benefit from holding the option, the value of the firm's stock must rise above the strike price (the prespecified price of the option). Thus, the executive has an incentive to increase the value of the firm. Options do not, however, expose managers to as significant a risk as compensation schemes, such as bonuses and stock awards, in which pay is explicitly lowered by poor performance. Milgrom and Roberts observe that the tradeoff between incentives and insurance implies that owners should

> [g]ive as much insurance as possible, which basically means reward people for success and try not to have them bear the costs of failures. Note that charging them for failures would accentuate the risk they already face [from managerial labor markets and the value of their human capital] and make them even more reluctant to recommend projects.
>
> Giving stock options to managers has this effect because successes are rewarded and there is no direct cost to failures. (1992, 431.)

In other words, the executive's possible gain from a successful project that increases the value of her options may outweigh the cost of potentially forgone gains. Managers may therefore be induced to choose riskier, profit-maximizing investments rather than safer, sub-profit-maximizing investments.[6]

6 Indeed, options may induce managers to indulge in excessively risky investment, as discussed below.

Another reason for the popularity of options results from current accounting principles. Although the Financial Accounting Standards Board in the United States has tightened some of the rules regarding the accounting treatment of stock compensation, anomalies remain. One is that the granting of stock options involves no accounting charges; boards may issue options to executives without incurring a bottom-line cost. This situation has led, some commentators suggest, to the excessive use of options as a compensation tool. Crystal states:

> [I]f you don't charge earnings for the cost of providing an economic benefit...you are likely to start thinking that benefit has no cost at all. And like any underpriced resource, you start to hand out too much of it. (1991b, 233.)

One cost of the overuse of options is the dilution of the value of shares held by other investors in the company. In Canada, this concern recently increased with the Toronto Stock Exchange's (TSE's) removal of its previous 10 percent limit on incentive shares (see Mackenzie 1995).

A further problem with options is their grantors' lack of commitment to a particular strike price. Crystal (1991b, 175–176) suggests that "an increasing number of boards are wont" to lower the strike price if the share price of the company falls dramatically. For example, he says, Frank Lorenzo of Texas Air held options with a strike price of $30.00 per share; when the share price collapsed, they were transformed into options with a strike price of only $4.625 per share. If boards cannot credibly commit to maintaining the specified strike price, the incentive to increase the value of the shares may be attenuated. If the stock performs poorly, the executive may simply lobby the board for a lower strike price.

Drawbacks. Because stock options reward an executive's success and do not penalize his failures with out-of-pocket costs, they may work too well, reducing risk aversion to an excessive degree. As Loomis states:

> In a totally rational world, top executives would get paid handsomely for first-class performance, and would lose out when they flopped. But to an extraordinary extent, those who flop still get paid handsomely. (1982, 42.)

Many commentators suggest that options fail to penalize flopping sufficiently and thus fail to provide executives with proper incentives. One manifestation of this failure is executives' assumption of risk that is excessive from the firm's point of view but not their own. If the gamble pays off, they will reap enormous windfalls from their options; if it does not, they will not suffer any out-of-pocket costs. One commentator puts the situation this way:

> There is a crisis in executive compensation, but the critics are looking at the wrong crisis.
>
> Most people think the problem is with compensation *levels*. They think American corporations pay their executives too much....But that is not the real crisis in executive compensation....The problem is the particular executive behavior that too many compensation plans motivate. Stock option plans specifically motivate executives to take strategic risks — often in the form of acquisitions — that are more hazardous than the shareholders desire. (Kay 1992, 1.)

Thus, options may be so successful in reducing risk to managers that agency costs may result.

Stock Appreciation Rights and Phantom Shares

In order to redress the dilution problem associated with stock awards and stock options, some firms have developed stock appreciation rights (SARs) and phantom shares. Milgrom and Roberts define *SARs* as

> [r]ights to collect the amount of any share price appreciation on a specified amount of common stock over time. (1992, 425.)

Thus, SARs align the interests of shareholders and executives insofar as they, like stock awards, induce the executive to maximize shareholder value. The dilution of existing shares, however, is eliminated since no new shares are actually issued.

Phantom shares act even more like an actual share award. Milgrom and Roberts define them as

> [u]nits that correspond to common stock but carry no ownership claims. These entitle the executive to receive the share price appreciation and dividends that would have been received on actual stock. (Ibid.)

Thus, phantom shares also provide executives with incentives similar to those of a stock award but avoid a dilution problem.

Compensation Levels

Thus far, the discussion has ignored the optimal amount or level of compensation. To address this issue, consider first the simplest explanation of compensation levels. Each worker is willing to accept a particular compensation scheme only if no other firm will offer her more; each firm is willing to compensate a worker up to the point at which it is no longer profitable to hire her at this level of compensation. Consequently, each worker will be paid the value of the marginal product of her labor. If executive compensation were governed by this algorithm, executives would be compensated (on average) at levels that corresponded to their marginal product.

Although paying executives the value of their marginal product may result in very high salaries (it is difficult to determine what executives' marginal product is), a different theory suggests that it may be appropriate to pay the CEO and other top executives explicitly more than their marginal product. Lazear and Rosen (1981) suggest that paying more than the marginal product to the winners of a competition may induce optimal behavior from all participants. If the prize at the top is sufficiently enticing, lower-level employees will compete for promotion, providing the firm with more produc-

tive labor at lower levels at lower costs. This *tournament theory* may explain the high levels of observed compensation at the top of hierarchies as well as the gap between the salaries of top executives and those of their immediate subordinates — the sub- ordinates accept less than their marginal product in order to remain in the race for the prize of a top executive's salary. Even Crystal, who does not accept this theory as empirically plausible, concedes:

> There is some intuitive support for the Tournament Theory. For example, think about how law firms run — or at least, how they use to run. A graduate fresh out of law school agreed to work for a law firm for close to slave wages in order to compete in a tournament that might end in a coveted partnership some seven years later. These young graduates might be argued to have contributed some of their true worth to a pool to be used to reward the winners of the tournament, the partners of the firm.[7] (1991b, 255.)

This lottery effect may be increasing in importance in firms as they reduce their layers of organization, thus increasing the numbers vying for promotion at each level. As Milgrom and Roberts put it:

> Firms' removal of layers of management has reduced the frequency with which promotions can be gained and the number of promotions that can be won....The leveling of organizational hierarchies has also probably increased the number of people at the lower rounds and, correspondingly, decreased the chances of winning promotion at these rounds. Both of these effects might well have adversely affected the incentives for middle-level managers. Any such negative incentive effects may have been offset by the impact of the recent increases in CEO compensation, however. Higher pay at the top of the hierarchy has increased the prize attached to winning in the last rounds and becoming an extremely well-paid senior executive, and thus may have increased middle-level managers' incentives to keep competing for promotions. (1992, 428.)

7 For an examination of the tournaments in US law firms, see Galanter and Palay (1991).

Thus, even if it could be shown for certain that executives were earning more than their marginal product, there is reason to suppose that this overpayment may be efficient. An inflated CEO compensation package may provide efficiencies by creating incentives elsewhere in the organization.

The Empirical Evidence

Although some analysts have recently examined executive pay in Canada,[8] most empirical studies of it are from the United States, where corporations have been compelled to disclose pay information since the early 1930s.[9] Indeed, the major US business periodicals (particularly *Fortune*, *Business Week,* and *Forbes*) publish spring cover stories largely devoted to listing the country's best-paid executives each year. These stories undoubtedly provoke strong reactions in their readers simply because of the remarkably high level of compensation that top executives earn. As already noted, Michael Eisner of Disney took home $203 million in 1993, which made him the highest-paid chief executive in the United States that year. His counterparts fared well also. The twenty-fifth-best-paid CEO in the United States that year, John Bryan of Sara Lee, had averaged more than $6 million annually in pay over the previous five years (Hardy 1994, 141). The Canadian evidence is less rich because disclosure of executive pay has been required for only a relatively short time. (Mandatory disclosure of the pay of each of the top five executives in publicly traded firms became law in Ontario only in 1993 — see the discussion below). As mentioned above, however, there are some notable data. Peter Munk, for example, has earned more than $30 million in a year, and Frank Stronach more than $40 million.

Although these figures are staggering, they are of dubious utility in assessing the appropriateness of executive compensation.

8 For example, KPMG (1995); Elitzur and Halpern (1995); and Magnan, St-Onge, and Thorne (1995).

9 Mandatory disclosure began with the *Securities Exchange Act of 1934*.

Very high salaries alone do not settle the issue or even significantly illuminate the matter. Consider, for example, that an *ex post* inquiry into Eisner's earnings at Disney would conclude that he earned monumental sums at the head of a thriving company. *Ex ante*, however, the compensation package he assumed was less striking, given that it was based on the performance of a company that, at the time, was a sluggish performer. While *ex post* Eisner earned astronomical amounts, this was the result of significant growth in the company (and shareholder wealth); it is difficult for an analyst to conclude that such a sum is excessive.

Brownstein and Panner (1992, 32) provide an interesting observation that further illustrates the weakness of rash inferences. When Time Warner CEO Steven Ross — to whom Crystal (1991b) dedicates a chapter entitled "The Prince of Pay" — was rumored to be seriously ill in December 1991, the firm's share price fell 4.75 points in five days (a drop of 1.0 point represented a loss of more than $90 million). In the same vein, Johnson et al. (1985) show that the stock market reaction to the unexpected death of a CEO is usually negative, indicating that he was not overpaid in the estimation of investors. Such evidence suggests a need for caution in casually asserting that executive compensation levels are too high.

A further reason for discounting the importance of "ten best-paid executive" lists is that they provide precisely what they say: extreme examples. Many executives are granted stock options which, when cashed, provide them with a significant, one-off gain; these sums are reported as their earnings that year, even though the options may have been granted over many years. As Milgrom and Roberts state:

> [T]he reported long-term incentive component of pay tends to be highly variable because the entire amount is reported in the year in which the gains are realized, even though they may be the result of several years' performance....Because the news stories tend to focus on the highest-paid executives in any year, this method of recording long-term compensation tends to bias the apparent income levels upward relative to the corresponding steady flows. (1992, 424–425.)

Thus, reports on the levels of compensation, although tantalizing, are not very helpful in assessing the efficacy of executive pay. Better evidence may come from other statistics, including those revealing the relationship between executive compensation and various measures of firm performance, the growth in executive compensation *vis-à-vis* corporate earnings or the pay of other workers, and international comparisons.

Executive Pay and Performance

Several studies examine the impact of corporate performance on the pay of senior executives. Given the significance of compensation schemes in aligning the interests of shareholders and managers, many commentators assert that, if compensation is not strongly linked to firm performance — in Loomis' language, if managers who "flop" are still rewarded "handsomely" — then compensation packages are inappropriate.

Several studies reach different conclusions on this matter. Milgrom and Roberts (ibid., 435n) note that the *Forbes* survey of 1990 found that the 25 highest-paid CEOs in the United States earned $2.26 for every $1,000 in revenues their companies generated, and $30.20 for every $1,000 in profits. Leonard examines pay patterns for more than 20,000 executives at 439 corporations between 1981 and 1985 and finds modest links between performance and executive pay; if a corporation's profits fell by $157 million (one standard deviation below the mean change in the sample), executive pay could be expected to fall by about 2 percent. He concludes:

> The level of executive pay cannot be justified in terms of contingent pay schemes when such a small proportion of executive pay is so weakly contingent. (1990, 21-S.)

Crystal takes a stronger view:

> [T]he bloated pay packages of American CEOs, with very few exceptions, contain hardly any pay risk. Those CEOs get paid hugely in good years and, if not hugely, then merely wonder-

> fully in bad years....Is the system rotten around the core or to the core? I'll take choice B. (1991b, 31.)

In general, Milgrom and Roberts report (1992, 438), when performance is based on accounting rates of return, the evidence across various studies is that top executives' pay typically increases by about 1 to $1^1/_4$ percent for every 1 percent increase in profit.

Jensen and Murphy (1990a) also find that executive pay is only weakly correlated with performance, but their conclusions are less adverse to the interests of executives. They study, among other data, the salaries and bonuses of 2,505 CEOs in 1,400 publicly held companies in the United States between 1974 and 1988, focusing on the change in executive pay associated with a change in shareholder wealth as measured by dividend payouts plus the change in the market value of the stock. They find that the median CEO's wealth (including changes in the probability of dismissal) increased by only $2.59 for every $1,000 increase in the wealth of shareholders. The figure fell to $1.93 when the executive's personal shareholdings were ignored. Using this focus on wealth, not profit, the authors find a correlation between performance and pay that is much weaker than previous studies had estimated,[10] which, they conclude, is evidence that CEOs' compensation levels are likely too low, probably for political reasons:

> How often do shareholder activists or union leaders denounce a corporate board for *under*paying the CEO? Not very often — and that's precisely the problem. Most critics of executive pay want it both ways. They want companies to link pay to performance, yet they also want to limit compensation to arbitrary amounts or some fuzzy sense of "what's fair." That won't work. Imposing a ceiling on salaries for outstanding performers inevitably means creating a floor for poor performers. Over time, by cutting off the upper and lower tails of the distribution, the entire pay-for-performance relation erodes. (1990a, 144.)

10 If the value of a company's stock is, for example, $1 billion, an increase in the present value of future profit of $1 million increases the value of the company by only 0.1 percent.

Elitzur and Halpern (1995) provide a study of the relationship between executive pay[11] and performance for 180 Canadian companies (in 13 industries) listed on the TSE. Like Jensen and Murphy, they find no strong link between compensation and performance. Indeed, they find no statistically significant relationship between the level of executive pay and firm performance in the sample companies. What they do find, however, is a positive correlation between the *change* in an executive's pay and performance from one period to the next.

Firm Size

The correlation between pay and firm size, a statistic perhaps related to the correlation between pay and performance, also inspires analysts to agreement about the numbers but disagreement about their implications. Almost always, the larger the size of the firm, the higher the level of executive compensation. As Milgrom and Roberts report:

> In study after study the same result appears, and the magnitude of the effect is remarkably stable across firms, industries, countries, and time periods: A 10 percent increase in sales results in about a 2 to 3 percent increase in salary plus bonus. Larger firms pay more, and when a firm grows, its pay rises to the level corresponding to its new size. (1992, 438, citing Rosen 1990.)

These uncontroversial figures, the authors continue, have generated diametrically opposed reactions. Some analysts claim that increased pay for increased firm size provides executives with perverse incentives; rather than maximize profits, they will maximize the size of the firm in order to feather their own nests with inevitably higher salaries. Other analysts suggest, however, that, if executives have a greater impact on larger corporations, given the greater number of

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11 "Pay" in this study includes cash compensation (salary and bonus) but, because of data problems, excludes deferred compensation and long-term incentive plans.

people and processes affected by their decisions, then their marginal products are higher than those of executives at smaller corporations. Consequently, the larger the corporation, the higher the pay should be.

Growth in Executive Compensation

Growth in levels of executive compensation *vis-à-vis* growth in corporate earnings or in lower-level pay is frequently referred to as evidence either of the inappropriate extremes that compensation levels have reached or of the soundness of executive compensation.

During the 1980s, executive compensation in the United States certainly grew at remarkable rates. According to *Business Week* (Byrne 1991, 90), the average pay of the top two executives at 365 of the largest publicly held US corporations grew by 212 percent over the decade. During the same period, the average teacher saw his pay increase by only 95 percent, the average engineer by 73 percent, and the average factory worker by only 53 percent. Also in startling contrast, the earnings per share of the Standard and Poor's 500 companies rose only 78 percent. Over the 1989/90 year, the profits of the firms surveyed by *Business Week* fell 7 percent, while average executive pay rose by 3.5 percent. There is at least some evidence that these trends are present in Canada as well. A study of 239 companies listed on the TSE (KPMG 1995) finds that the total pay of CEOs increased by 18 percent in 1994, while Statistics Canada reports that the average pay of unionized workers rose by only 1.8 percent in the same year (Hameon 1995).

The disparity in growth rates between executives' and other workers' pay and between executives' pay and earnings per share is difficult to explain. As Byrne says, "[e]conomists who study the issue are at a loss to explain the growing disparities in rational terms" (1991, 90). If the productivity of the firm is growing generally, one would expect executives' pay, other employees' pay, and earnings per share to move in approximately the same direction. If all three statistics were at approximately appropriate levels at the beginning of the 1980s, the only rational economic explanation for the current

disparity is that the productivity of executives has enjoyed idiosyncratic growth. On the other hand, if executive compensation was lower than appropriate at the beginning of the 1980s, then its rapid growth may simply be the result of the market's rational adjustment to a long-run equilibrium. Jensen and Murphy take the latter position, stating:

> Despite the headlines, top executives are not receiving record salaries and bonuses. Salaries and bonuses have increased over the last 15 years, but CEO pay levels are just now catching up to where they were 50 years ago. During the period 1934 through 1938, for example, the average salary and bonus for CEOs of leading companies on the New York Stock Exchange was $882,000 (in 1988 dollars). For the period 1982 through 1988, the average salary and bonus for CEOs of comparable companies was $843,000. (1990, 138–139.)

In brief, despite widespread agreement that executive compensation has indeed risen over recent years at a rate greater than other employee compensation or corporate earnings, there is disagreement over the reasons for this disparity.

Other Employees' Compensation

A related gauge of the heights that compensation levels have reached is the ratio of executives' pay to workers' pay. Crystal (1991b, 29) reports that, in 1991, the average executive's compensation was 130 times the average worker's — after he removed some peculiarly high executive compensation packages from his calculation.[12] Bok (1993, 102) notes that executive compensation was more than 100 times greater than the average wage in the United States in 1990.

Bok, Crystal, and others suggest that these ratios are exorbitant. Crystal (1991b, 24) points out that Plato once told Aristotle that "no one in a community should earn more than five times the pay of the

12 Including these outliers raised the ratio to 160 times the compensation of the average worker.

lowest-paid worker"; Crystal also notes that, a little more recently, Peter Drucker, a management theorist from California, suggested that no executive should earn more than 20 times the pay of her lowest-paid worker. These suggested ratios have been dwarfed by the pay earned by CEOs at many corporations. For example, in 1989, Steven Ross of Time Warner earned 9,000 times the pay of the average worker (ibid., 28); in 1990, Michael Eisner, who made $11.2 million that year, earned more in a day than the average Disney worker earned in a year (Byrne 1991, 91). Although these figures illustrate the significance of large sums of money, alone they fail to offer a normative benchmark with which to judge ratios, other than an elusive tweak of many people's sense of social justice. Like the growth in executive compensation levels, the growth in the ratios of executive compensation to average compensation provides a more enlightening picture. Crystal (1991b, 27) reports that, in 1974, an average CEO earned 35 times the pay of an average manufacturing worker, whereas in 1991 the multiple was nearly 120. The suggestion again is that, unless CEOs' productivity has enjoyed idiosyncratic growth, their compensation is at least suspect. Recall, however, Jensen and Murphy's contention that this growth in executive pay represents the market's finding its long-run equilibrium, after past undercompensation.

International Comparisons

Commentators repelled by the compensation levels of top executives, particularly in the United States, frequently cite the contrast between domestic and foreign executives' pay. Such comparisons were particularly encouraged in January 1992 when US President George Bush traveled to Japan accompanied by several of his country's top CEOs. As Bok states:

> The subject of executive compensation boiled over and became a public issue only after automobile executives traveled to Tokyo on a trade mission with President Bush. The sight of Lee Iacocca complaining [about unfair trade conditions] to leading Japanese

> executives making only a fraction of his pay was a spectacle that no reporter could resist. The stories that ensued provoked an angry reaction. (1995, 95.)

On its face, this reaction appears justified. Crystal (1991b, 28–29) states that, while executives in the United States are compensated at a rate equivalent to 130 times the pay of the average worker, the comparable figure in Japan is less than 20 and in the United Kingdom, less than 35.[13] Illustrating the point in a different way, the author continues, the average CEO of some of the largest 200 companies in the United States earned $2.4 million in 1991, which was seven times greater than the pay of the CEO of a large Japanese firm in that year. US executives are also paid better than their Canadian counterparts. According to Milgrom and Roberts (1992, 426), the average Canadian CEO earns approximately 65 percent of what a US CEO takes home.

These examples of executive pay in highly competitive countries are frequently viewed as particularly damning to defenders of managerial pay levels in the United States. The statistics also reveal that, although Canadian CEOs earn only a fraction of what US executives earn, they make more than their Japanese counterparts. These differences lead to conclusions such as Crystal's:

> Granted the cultures [of Japan and the United States are very different, and, unhappily, so are the products. The Japanese make better cars than we do, and they offer them at better prices. The Japanese culture may be different, but that different culture is killing us. So, to dismiss different executive pay levels in other countries against whom we compete every day in the international and domestic markets is plain fatuous. (1991b, 30.)

On the other hand, some commentators suggest that the contrast in pay between countries may be less dramatic than the statistics suggest. They assert that nonmonetary forms of compensation, such

13 According to Crystal, of the United Kingdom, Japan, Germany, and France, only the United Kingdom "show[s] signs of catching the US executive compensation virus, and it has only a mild case" (1991b, 28).

as club memberships and company housing, as well as much greater job security, explain much of the gap in pay between, for example, the United States and Japan. Liebtag states:

> In spite of a lower salary, however, the Japanese executive — still most often a male — is probably as well treated as his Western counterpart. He often receives many valuable perquisites, including a liberal expense account that covers some household expenses normally treated as personal obligations in the United States. In addition, the average executive continues to work or at least continues to draw a salary and receive perks many years longer than in the West....Finally, executives and managers are likely to be among the 35 percent of the Japanese work force that enjoys lifetime employment. (1991, 30.)

Thus, the compensation gap that critics cite as evidence of the egregious levels of executive pay in the West may be narrower than is often suggested — or indeed may not exist at all.

Tournament Evidence

Even if it could be conclusively proven that executive compensation exceeds reasonable economic benchmarks, such as marginal product, CEO sympathizers might respond by citing the tournament theory, which, as already discussed, holds that overpaying top executives creates efficient incentives throughout the organization, lowering the overall wage bill. The evidence on the tournament theory is mixed. To assess the effect of prize structures on incentives more generally, Ehrenberg and Bognanno examine the effect of prizes on the performance of professional golfers on the US Men's Professional Golf Association (PGA) Tour in 1984. They find evidence consistent with the tournament theory of compensation:

> Higher prize levels do lead, other things equal, to lower scores.... Given a player's performance in the first three rounds of the tournament, his performance in the last round also appears, other things equal, to depend on the marginal returns to effort he faces, with players who face larger marginal returns scoring

> lower. The level of prize money in tournaments also influences who enters the tournaments, with higher prize money attracting better...players. (1990a, 1322.)

These results should not be construed as peculiar to North American culture; Ehrenberg and Bognanno get very similar results from a study of the effects of prize structures on performance in the European PGA Tour (1990b).

Leonard finds evidence supporting the tournament theory of compensation in his study of the pay structures facing over 20,000 executives in 439 corporations between 1981 and 1985. The central proposition of the tournament theory is that mid-level executives are willing to accept lower wages in order to compete for future prizes. This seems likely to be true only if the prize increases as the probability of success falls; remote possibilities should have larger payoffs if they are to provide incentives. Leonard finds that as the promotion rate to the next level of the corporate hierarchy increases, the pay differential falls. He concludes:

> There is some evidence consistent with a tournament or lottery view of executive compensation. In such models, high pay in top executive positions is used to motivate lower-level executives to compete for promotions. The expected value to executives of such a scheme can be maintained if the pay differential across levels narrows while promotion probabilities increase.... Steeper pay differentials are indeed associated with lower promotion rates. (1990, 27–S.)

Crystal reaches the opposite conclusion, claiming that high pay for a CEO is typically accompanied by high pay throughout the firm. He says of the tournament theory:

> Nice theory, but it doesn't work....[R]esearch I have conducted shows that if the CEO is being paid above the market, so will his number two executive be paid above the market (although not perhaps by as much). And so will his number three executive. And on and on. (1991b, 256.)

In brief, despite some empirical support for the tournament theory, it is at least qualified by inconsistent evidence.

Other Evidence

Critics of executive compensation packages often focus their attention on the increased use of incentives, such as stock options, that are not accompanied by an according reduction in the base salary. Even Milgrom and Roberts, who are generally agnostic on the subject, note that,

> [b]ecause it often seems that large US firms add various long-term incentive pay components to their CEOs' compensation packages without obviously decreasing any of the other elements, knowledgeable observers of executive compensation consider these long-term programs the source of the relative jump in CEO pay in the 1980s. (1992, 427.)

They also observe an

> apparent tendency of boards to add new items to CEOs' compensation packages without adjusting the size of existing ones. Given this, a recommendation to increase the linkage between CEO and shareholder wealth through stock awards amounts to an invitation to bestow large amounts of stock on the CEOs, giving away even more of the shareholders' money to already well-paid executives. (Ibid., 441.)

The implication of these empirical observations is that executive compensation packages may be excessive.

Countering this assertion, however, is evidence of the efficacy of incentive programs. Market-based (rather than accounting-based) studies of these programs' effects recommend them. Tehranian and Waegelein (1985, 131) find that, after a company announces the introduction of executive compensation packages tying pay to accounting performance, the share price immediately jumps 11 percent. Brickley, Bhagat, and Lease (1985, 151) observe that adopting a long-term incentive plan increases the return to shareholders by 2 percent.

Abowd (1990, 52-S) finds from his study of more than 16,000 managers at 250 large corporations over the 1981–86 period that accounting performance is only weakly improved by an increase in the sensitivity of managerial pay to performance, but market responses (shareholder returns) are significant and positive. Although these studies do not rebut the assertion that compensation packages are excessive,[14] they do put in question the claim that such schemes are implemented *only* to feather executive nests.

The Law of Executive Compensation

Executive compensation is given within a country's framework of corporate law and its application. The legal situation in Canada,[15] as in the United States, sometimes has interesting effects.

Directors' Duties

The legal responsibility for setting the compensation of a corporation's executives rests with its board of directors. For example, the *Ontario Business Corporations Act (OBCA)* states:

> Subject to the articles, the by-laws or any unanimous shareholder agreement, the directors of a corporation may fix the remuneration of the directors, officers and employees of the corporation. (Sec. 137.)

Although this approach leaves wide scope for discretion, it is constrained by the fiduciary duty owed by directors and officers of the corporation. Under the *OBCA*, for example, all directors and officers must act "honestly and in good faith with a view to the best interests

14 They may be better than previous compensation schemes, but still excessive.

15 Canadian securities law falls largely under the jurisdiction of the provinces. The framework described here is Ontario's because almost all large public corporations in Canada are listed on the TSE.

of the corporation" (sec. 134). Thus, the legal obligation on directors is to set compensation levels for officers (and directors) that maximize the value of the company.

Although the obligation is clear, the enforceability of such a duty is suspect. Indeed, the law is not encouraging to those who wish to challenge the directors for breaching their fiduciary duty in setting compensation. In an important 1933 case (*Rogers v. Hill*) on the duties of directors with respect to compensation, the US Supreme Court held that a compensation scheme that had been ratified by shareholders 20 years earlier and that in 1930 had resulted in a payment of more than $1 million to the CEO of American Tobacco Company was "valid when adopted," although it also noted that freedom of contract "cannot...be used to justify payments of sums as salaries so large as in substance and effect to amount to spoliation or waste of corporate property." The case was later settled before it could be determined whether the scheme in question amounted to corporate waste, but the decision set a high standard for those wishing to challenge compensation schemes: if the scheme is originally valid, it will stand unless egregious.

The court's recognition of both "its power to limit executive pay, and its...reluctance to do so" (Shorten 1992, 149) has generally characterized judicial attitudes to the review of executive compensation. A later law suit over compensation to American Tobacco executives led the New York Supreme Court to write the following frequently cited passage on the limits of the courts' competence to review executive compensation packages:

> Assuming, *arguendo*, that the compensation should be revised, what yardstick is to be employed? Who or what is to supply the measuring rod? The conscience of equity?....Can equity be so arrogant as to hold that it knows more about managing this corporation than its shareholders?
>
> Yes, the court possesses the power to prune these payments, but openness forces the confession that the pruning would be synthetic and artificial rather than analytical or scientific. Whether or not it would be fair and just is highly dubious. No blueprints are furnished. The elements to be weighed are incalculable, the

> imponderables manifold. To act out of whimsy or caprice or arbitrariness would be more than inexact — it would be the precise antithesis of justice; it would be a farce. (*Heller v. Boylan*, 1941.)

Thus, while courts have long recognized their power to review compensation, they have also refrained from doing so, typically out of a mistrust of their own ability to handle such an issue.

Shareholders and Executive Compensation

Canadian corporate law permits shareholders direct participation in some corporate decisions through shareholder proposals and votes (see, for example, *OBCA*, sec. 99.) These votes may not, however, cover issues that are considered "ordinary business." Unfortunately for potentially activist shareholders, the setting of executive compensation is considered "ordinary business" in Canada, so direct shareholder participation through proposals is proscribed.

On the other hand, recent developments in securities law have enhanced the ability of shareholders to monitor directors' decisions about executive compensation. In October 1993, the Ontario government adopted an order-in-council making various reforms to the *Securities Act* regulations. A fundamental change was the requirement that the compensation of the CEO and the four highest-paid executive officers of Ontario issuers be disclosed in a variety of tables, rather than in a potentially confusing narrative.[16] The issuer is also required to disclose details of the repricing of any options or SARs in the past year and any other repricings over the past ten years and to give reasons for these decisions. To aid the assessment of the propriety of the composition of the compensation committee, which the board frequently appoints to handle its compensation decisions, the issuer is compelled to outline conflicts such as *interlocks* (for

16 The tables required by the new rules include a summary compensation table, a long-term incentive plan awards table, an options/SARs granted table, an options/SARs exercised table, a table for defined benefit and actuarial plans, and a table for executive indebtedness.

example, two directors sit on at least two compensation committees together) present in the committee. Finally, the issuer must provide graphs plotting the shareholders' return alongside the returns to a comparable market or industry index. Aside from these technical requirements, the issuer is also required to outline the compensation philosophy of the corporation, including a discussion of pay/performance linkages.

These reforms bring Ontario law in line with the revisions adopted by the US Securities and Exchange Commission (SEC) in October 1992.[17]

Reform Proposals

The legal framework just outlined has been criticized in many quarters. Critics take aim particularly at the potential for conflicts of interest on the board. Other commentators focus their suggested reforms on shareholders, the courts, and tax law.

Boards and Executive Compensation

That the potential for unhealthy conflicts of interest over compensation decisions exists on many boards is undebatable. One cause is the presence of insiders. Officers of the corporation frequently sit on the board. This situation creates a clear conflict of interest if all directors vote on compensation — the inside directors then vote on their own compensation. Despite this opportunity for blatant self-dealing, the law does not distinguish between inside and outside directors; rather, it states that the board as a whole is responsible for compensation decisions (see, for example, *OBCA*, sec. 137).

In recognition of this potential conflict, many firms establish compensation committees comprised solely of outside directors to make recommendations about compensation to the board as a whole.

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17 For an extensive outline of these US reforms, see Bakris (1993).

Insider problems still exist, however. Milgrom and Roberts explain one that is obvious: "Often, but not always, the compensation committee is composed exclusively of outside directors....Nevertheless, the CEO is usually a member of the committee *ex officio*" (1992, 434). Indeed, the CEO frequently makes the initial compensation suggestions for the committee to deliberate.

Other self-dealing problems are more subtle. In many corporations, for example, the chairman of the board is also the company's CEO. Thus, the composition of the board is largely controlled by the company's executives, a situation that implies the possibility of stacking the board with directors friendly to the CEO.

A phenomenon frequently observed, particularly in a relatively small economy such as Canada's, is interlocking directorships, whereby directors may be "top executives of other corporations on whose boards the chief executive officers may sit" (Elson 1993, 942). Such a situation is clearly tainted by the possibility of an "I'll scratch your back if you scratch mine" mentality toward executive compensation, which may influence the CEO to search out such directors.[18]

Even if the directors are not predisposed to the executives through social connections or interlocks, directorships have advantages with which individuals may be reluctant to part. Some are nonpecuniary. The prestige associated with the role alone may leave directors reluctant to endanger their positions on boards, and conflicts with executives over such a potentially volatile matter as executive pay may be one way to endanger these positions, particularly if the CEO is chairman of the board.

Of rising concern are the increasingly attractive pecuniary advantages of directorships. *Business Week* reports that, in 1990, the average pay of directors of 352 companies was $32,252 for only 92 hours of work (Dobrzynski 1991, 94), while the directors of Pepsico, for example, each took home $78,000 that year. This money is

18 The conflicts inherent in these insider situations led the general counsel to the California Public Employees' Retirement System to observe that having a CEO as chairman of the board is "like grading your own papers" (quoted in McMenamin 1994, 143).

not insignificant to many people. For example, the dean of Northwestern University's Kellogg School of Management earned at least a third more from his service on several boards than he did from the university (Lublin 1991, B-1). In Canada, too, directorships have the potential to be very lucrative. For accepting directorships at American Barrick and Horsham, two companies controlled by Peter Munk, Brian Mulroney was granted stock options that, if exercised when granted, were worth $1.5 million;[19] this came on top of his pay of $12,000 per year per directorship, $600 per meeting attended at American Barrick, and $1,000 per meeting attended at Horsham (McKenna 1993, A1).

With such sums being paid out, recent years have seen an increased focus on director compensation. As McKenna reports, Mulroney's compensation "raised concerns among compensation specialists and shareholders-rights activists" (ibid.). One concern is about sheer excess and the suboptimal use of corporate resources in director compensation, just as in executive compensation. Another concern is that these pay packages may actually induce suboptimal behavior simply by their level. The risk of possible ousting from the board and subsequent loss of such significant pecuniary advantages may leave otherwise independent directors reluctant to challenge executives' suggestions, particularly those about executive compensation. Although the board is responsible for setting directors' pay, in practice that pay is approved by the board but suggested by the CEO. Well-paid directors may show their gratitude for the CEO's largesse by approving correspondingly high executive pay. Thus, the recent tendency toward increased pay for directors may both waste corporate assets in itself and provide them with undesirable incentives that lead to further waste of those assets.

Another problem with the potential influence of executives rests with the increasingly frequent use of compensation consultants, who are often hired by the CEO to assist compensation committees.

19 None of these options could be exercised for a year; after that, a third of the Horsham options and a quarter of the American Barrick options could be exercised annually.

The danger is that the consultant and, therefore, the compensation committee will be influenced by executives of the company. Consider the following anecdote Crystal tells about his own experience as a practicing compensation consultant:

> I recommended that [the CEO] cut his salary to $100,000 [from $160,00] to make room for a normal 60%-of-salary bonus opportunity. I explained to him he would in a year of normal performance earn what he was earning now; in a year of above-normal performance, he would earn more than he was earning now; and, fair is fair, in a year of below-normal performance, he would earn less than he was earning now.
>
> The CEO did not take kindly to my suggestion. First, he tried to argue me out of the recommendation....But he wasn't successful. So he looked me in the eye and posed a question to me that I will never forget: "Just who do you think is paying your bills, anyway?"....[W]e broke up, and I have never heard from him again. I'd bet, however, that he found another compensation consultant who was willing to recommend that the company adopt a new annual incentive plan without requiring executives to cut back on their base salaries. (1991b, 219.)

Aside from such explicit conflicts of interest, some commentators contend that most directors are relatively uninformed about the intricacies of executive compensation,[20] and have no significant incentives to learn about them. Unlike the astronomical salaries that occur in, for example, professional sports, the pay of executives results not from a negotiation between two parties who have a financial interest in the outcome (such as the team owner and a professional baseball player),[21] but rather between the executive who has a direct financial interest in the outcome and directors who have little at stake financially other than the potential of being ousted from the board.

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20 As Barris states, "Because these committees are composed of other executives, not compensation specialists, they often lack technical expertise in compensation issues" (1992, 76).

21 See the discussion in Crystal (1991b, 31–37).

One result of this asymmetry is that directors, rather than negotiating earnestly on behalf of shareholders, are content to rely on comparison studies. They may even ask the compensation consultant to set pay higher than the average "to attract a better grade of executive." That suggestion often originates with the incumbent executives, according to Crystal, who comments:

> It wouldn't be so bad if some companies, as a matter of policy, paid above the average so long as other companies, also as a matter of policy, paid below the average. But that almost never happens. In one survey I conducted some years back of one hundred companies' pay policies, thirty-five stated that they were aiming for the 75th percentile of the distribution, sixty-five state that they were aiming for the competitive average, and none stated that they were aiming for a position below the average. (Ibid., 223.)

In such a situation, executive pay will race to the top as lesser-paid executives receive raises to the median level or above, increasing next year's median pay, which, in turn, increases the raises for executives the following year.

In sum, the setting of executive pay is rife with potential conflicts of interest and inherently flawed because of the divergence in economic interests between the executives, who are directly concerned with compensation, and directors, whose interest is attenuated.

Suggestions for Reforming Boards

A viable solution to the potential problems raised by the legal framework for executive compensation is easy to state but more difficult to implement. As Elson puts it:

> The solution lies in loosening the outside directors' ties to management and recreating a vital and independent board, which will result in active oversight, not passive agreement. A way must be found to reinvigorate the outside director who traditionally acted in the shareholders' interests by directing management. (1993, 942.)

The challenge is to suggest reforms that would accomplish this uncontroversial solution.

Directors' Fees. Elson, who believes that the way directors are paid contributes significantly to the problem, suggests that paying them in equity, not cash, would better align their interests with those of the shareholders whom they represent. Furthermore, to enhance their independence by diminishing the threat of removal from the board, he suggests that their terms be extended. He states:

> [C]orporations should pay their directors their annual fees in restricted company stock. In a few years, each outside director will have accumulated a reasonably substantial portfolio and, therefore, will possess a powerful financial incentive to act more independently of management. Additionally, directors' term lengths must be significantly extended to ensure that their equity positions (or potential positions) will reach the levels necessary to influence their decision-making and to mitigate the chilling effect of a management threat not to renominate that frequent elections create. (Ibid., 944.)

Compensation Committees. Other commentators focus on increasing the independence of compensation committees. Currently, most such committees operate by reacting to proposals put before them, either by the executives themselves or by consultants hired by the executives. As Barris says, "committees themselves rarely initiate the plans"(1992, 76). Crystal proposes a more proactive approach: that compensation committees be "mandated" to hire their own compensation consultants who "would not be permitted ties of any sort with the company's management" (1991, 242–243). To encourage monitoring of particular consultants, a company would have to include in its proxy statement each year the name of its consultant and if he were fired, the company's reasons for doing so, and the consultant's reply. Such reforms, Crystal suggests, would reduce the direct and indirect (through "captured" consultants) influence that executives often have over the compensation committee.

Like Elson, Crystal takes aim at director compensation, although his concern is with how much directors are paid. He suggests setting their pay with reference to external factors:

> To dampen the incestuous relationship between the pay of the CEO and the pay of the outside directors, boards should adopt policies that peg their own pay to the median of a group of like companies....In short, they should insulate themselves from being bribed by a CEO who is bent on improving his own pay package. (Ibid., 245.)

US Representative Ed Markey proposes another reform aimed at controlling the capture of directors: that legislation restrict the members of compensation committees to outside directors;[22] furthermore, to control interlocking directorships, directors would be limited in the number of compensation committees they could serve on simultaneously (Jones 1993, 1B).

Other Proposals. Other proposed reforms are aimed more generally at providing directors with a legal framework that would better induce them to act in the best interests of the shareholders, not of management or of themselves. Although I lack space for a survey of these more general reforms here, one frequently advocated proposal deserves mention. Many commentators recommend that a CEO be prohibited from serving as chairman of the board or perhaps as a director at all.[23] This reform is addressed at minimizing the potential for the capture of other board members by an insider acting as their boss.

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22 This was also recommended by the London Stock Exchange's Greenbury Committee in its report on executive pay. See "Fat Cats and Their Cream," *The Economist*, July 22, 1995, p. 19.

23 For a discussion of this proposition, see McMenamin (1994). Crystal (1991b, 245) discusses Jay Lorsch's suggestion that CEOs not be permitted to serve on boards at all.

Shareholders

Although most commentators agree that the concern about excessive executive compensation lies with the potential for conflicts on the board of directors, some choose to focus their reform efforts on other institutions that may be able to control the board's behavior. Increasingly, shareholders are being targeted as protectors of their own interests, and policies are being suggested to facilitate their activism.

The central drawback to relying on shareholders to fend for themselves is the familiar collective action problem: since each shareholder in a widely held corporation receives only a fraction of the benefits of controlling compensation excess, each has only a sub-optimal incentive to undertake costly monitoring and disciplining activities. As Daniels puts it, "Since the benefits of governance activity are not confined to the activists, shareholders will be encouraged to remain rationally apathetic" (1994, 44). Reforms, therefore, frequently center on reducing the cost of monitoring and/or disciplining actions.

Increased Disclosure. One such reform that has been adopted in both Canada and the United States is increased disclosure of compensation packages. With the cost of investigating the propriety of executive compensation packages reduced through mandated disclosure (including an explanation of the firm's pay philosophy and comparisons with the performance of similarly situated firms), larger shareholders, particularly institutional ones, may face sufficient incentives to act to control executive compensation, notwithstanding collective action problems. As Daniels states:

> The revised regulations [on disclosure] will enhance the incentives of both directors and institutional shareholders to review and control executive compensation arrangements. Under the sunlight of heightened disclosure, compensation committees will be encouraged to devise compensation arrangements that meet shareholder expectations. (Ibid., 41.)

Optimism seems particularly justified in Canada, where institutional investors frequently hold a significant percentage of a company's shares.[24] Although each can still reap only a fraction of the benefits from activism, collectively they can realize a much higher fraction than institutional investors in the United States, who typically hold a smaller percentage of shares.[25] Nevertheless, US institutional shareholders do frequently challenge compensation agreements, and commentators often look to them to play such a role (see, for example, Barris 1992).

Increased Shareholder Voice. Although disclosure rules reduce the cost of monitoring executive compensation, they do not help in reducing the cost of activities designed to alter compensation packages. In the United States, the SEC has changed its policy of disallowing shareholder proposals regarding executive compensation (for discussion, see Ragsdale 1993, 551). Shareholders may now vote in their proxy materials on "advisory" (nonbinding) shareholder proposals regarding executive compensation. SEC Chairman Richard Breeden outlines the reasoning behind this policy shift:

> Hopefully, this decision will bring a market solution to a market problem by allowing the affected private sector groups — management, directors and shareholders — to resolve the compensation questions in each company on a case-by-case basis without government regulation. (Quoted in Barris 1992, 91.)

Proponents of combining increased disclosure with increased scope for shareholder voice hope that these reforms will reduce the cost to shareholders of controlling executive pay.

24 For discussions of the role of institutional investors in the Canadian setting, see Daniels and Waitzer (1994); and MacIntosh (1994).

25 Barris (1992, 89) reports that the top 20 institutional investors in the United States hold only about 16 percent of the shares in the ten largest US corporations

Drawbacks. Others argue, however, that such reforms are at best unnecessary and at worst liable to lead to what Pound calls "uncertainty and dislocation" (1992, A12). He cites the case of Westinghouse as an example of the potential for shareholder activism that existed under the US regime before the recent SEC reforms. Various institutional investors and other shareholder activists objected to the company's compensation structure and threatened significant unrest (such as a variety of shareholder proposals) unless the problem was addressed. In response, Westinghouse executives met with the concerned shareholders and subsequently altered the compensation arrangements with the aid of an independent compensation committee that used its own consultants. The incident illustrates, Pound contends, that the system was effective without reform.

Brownstein and Panner are sympathetic to this view. Of the SEC reforms, they state:

> While significant, this change in long-standing SEC policy is dwarfed by the already powerful voice of institutional investors. Even before the regulatory changes were made, companies met with their largest shareholders to discuss the way senior executives should be compensated. (1992, 34.)

Other commentators express concern about the costs of disclosure. Some cite the cost of compiling the tables and charts:

> [I]t is important to ask the question: disclosure at what cost? And, it appears that one thing is certain about the new [SEC] regulations — that is that companies will incur increased costs in compliance. (Ragsdale 1993, 569.)

Others point to the cost to the executives from an invasion of their privacy. The CEO of Stelco, for example, says that requiring disclosure "does tend to invade privacy" (quoted in Stinson 1993, B1). Some critics go so far as to worry that disclosure of high salaries will increase dangers of kidnapping (ibid.).[26] In brief, although many

26 Ken Hugesson, a Toronto compensation specialist, replies that criminals do not need a prospectus to find Forest Hill (a wealthy residential area of Toronto) (Rusk 1993, B1).

commentators applaud encouraging investor activism with increased disclosure, others would prefer a more cautious approach.

The Courts

As discussed above, the law requires that directors act in the best interest of the corporation. Granting excessive (not simply high) pay packages to executives is clearly not in the best interest of the corporation, and directors who act in such a fashion are in apparent contravention of the law. Yet, as also noted above, the courts have been historically reluctant to interfere with the business judgment of directors, so long as proper procedures have been followed. Many commentators advocate reform of this passive judicial approach.

In a relatively early paper on controlling compensation excess, Vagts (1983) suggests that the courts have the potential to play a significant role in overseeing boards of directors in setting executive pay. He and others (for example, Barris 1992; Bogus 1993; Shorten 1992) note that the courts, although not compensation experts, have shown readiness and ability to rule on excessive compensation in closely held corporations and in tax cases. These commentators suggest that, although judging whether compensation levels are excessive is not an easy task for the courts, it is possible and indeed undertaken in other contexts. The courts should, therefore, hold directors to a standard stricter than that to which they are currently held. Vagts suggests that, in cases in which the rules of corporate governance and shareholder activism are inadequate,

> [a]s a last resort we look to the courts....[C]ourts need to understand that while judgments on the excessiveness of executive compensation are not easy to make, they usually are not impossible....[C]ourts can and should carefully scrutinize compensation that is substantially out of line and prune off the abnormal amount when not justified by special risks run by the executive recipients or special contributions made by them. If the courts act, even occasionally, to trim compensation it will, in turn, be easier for compensation committees to tell executives that they simply cannot gratify their pocketbooks and egos as much as the executives demand. (1983, 275–276.)

Tax Law

Some commentators, despairing of reforming the governance of executive compensation either internally through board or shareholder solutions or externally through the courts, suggest the admittedly more blunt instrument of tax policy. Tax law, allege supporters of this approach, could make high salaries more expensive to the corporation; consequently, firms would use greater care in setting compensation.

In the United States, where executive compensation has attracted substantial political attention, as many as six compensation related bills were before Congress in 1992 (Barris 1992, 79). Eventually, Congress passed the ***Omnibus Budget Reconciliation Act of 1993***, which eliminates corporate tax deductions for executive compensation greater than $1 million that is unrelated to performance. As Barris explains:

> The theory behind these bills is simple: Public policy does not support extreme distortions in income distribution, and taxpayers should not have to subsidize high-level executives through business tax deductions. (Ibid.)

Conclusion

This paper has reviewed some of the central theoretical, empirical, and legal literature on executive compensation.

The theoretical literature is both vast and complex. There is no simple economic optimum for a compensation package. In some situations, an emphasis on bonuses is appropriate to motivate executives to put forth optimum effort; in other cases, the private risk facing the risk-averse executive as a result of such an emphasis encourages suboptimal risk taking. Stock options can mitigate the risk associated with providing executives with incentives, but they may encourage managers to undertake investments that are excessively speculative. In yet other situations, paying executives more than their marginal product may minimize the overall wage bill by establishing a prize over which lower-level employees will compete.

Thus, the only firm conclusion to be drawn is that compensation is potentially very important to the health of a company, but no simple formula can capture the optimum arrangement in every situation. As *The Economist* states, "pay can have a powerful effect on managerial behaviour. It is worth getting right" ("Fat Cats and Their Cream," July 22, 1995, p. 19). This may, however, be easier said than done.

The empirical evidence is mixed. Although compensation levels, particularly in the United States, can be very high, this fact does not in itself indicate that they are excessive. Of more concern is the fairly consistent finding that performance and pay appear to be only weakly linked; if this is true, current compensation packages may be providing too few positive incentives. Also of note is the apparent divergence in the growth of the pay of executives and of other employees over recent years. Although some commentators view this divergence as evidence of executives' greed, other suggest that the market is correcting for their historical underpayment. International comparisons are inconclusive as well. Some analysts find that US executives (and, to a lesser extent, Canadian executives) are overpaid relative to their Japanese counterparts, but others claim that this divergence disappears if perks are included fully in pay. The tournament theory of executive pay also draws mixed reactions: some find evidence supporting it, others claim the theory does not work. There is, however, fairly strong market evidence that the introduction of incentive plans to executive pay increases expected profits as reflected in share values. This increase at least suggests that, although incentive pay may be unnecessarily high, it has positive effects on shareholder income.

The legal literature focuses on the potential for self-dealing present in the corporate law regime governing executive compensation. The suggestion is that executives have the potential to unduly influence directors, who have at best only an attenuated financial stake in the compensation decision. Reformers suggest that boards, and particularly their compensation committees, be redesigned to encourage independence from executives. They also recommend

that the potential power of institutional investors be more fully realized by facilitating monitoring and other forms of activism. Some commentators urge the courts to reject passivity and actively review excessive compensation packages. Finally, others suggest changes to the tax laws designed to limit executive pay.

An appropriate conclusion to draw from this survey is that simplistic conclusions about executive compensation are unlikely to advance the debate; it is far too complex for black-and-white thinking.

Future Research

There are several potentially fruitful areas for future research on executive compensation. One relates to the theory of compensation and motivation. As discussed above, bonuses and other forms of contingent pay may induce optimal effort from an executive by offering an opportunity for personal gain. On the other hand, contingent pay may induce risk-averse managers to choose safe but sub-profit maximizing investments.

According to the latter theory, one would expect that particularly risky industries would not offer risky pay structures. In reality, however, no correlation between safer pay packages and risky industries is immediately apparent. Further research might identify this lack of correlation more clearly, leading to a possible alternative theory of contingent pay. If a job is inherently risky and the pay schedule cannot entirely insure against this risk (perhaps because of the managerial labor market), risk aversion may be an undesirable feature in a manager. To account for this, risky pay packages may be offered not to induce optimal effort but to deter risk-averse candidates. If the variance of executive pay is sufficiently large, risk-averse individuals may be deterred from pursuing such positions, while more risk-neutral candidates may find such a package attractive. In other words, risky pay may be associated with risky management positions not to induce effort but to screen out risk-averse managers.

Another potential area of future study is the effect of stock options. Some people say that such compensation is risk free for

managers. This is not true. If the firm performs well, the options will be valuable; if it performs poorly, the options will have little value. Thus, what options limit is out-of-pocket risk; the manager who receives them still risks forgone gains if the company does not perform well. Yet, although a forgone gain is equivalent to an incurred loss in theoretical economics, behavioral studies suggest that an out-of-pocket loss is more significant to many people than an opportunity cost (see, for example, Knetsch 1989). A study of the risk properties of stock options might be informed by an analysis of this perceived difference between types of cost.

A further area of study with respect to stock options is their repricing when share prices fall. Some commentators conclude that such repricing is evidence of the influence that executives wield over the board. Consider, however, the incentive properties of an "underwater" option (one in which the strike price is greater than the share price). If the option price is much higher then the share price, an executive may face two choices. She may simply give up on ever exercising it, in which case the option has no incentive effect. Alternatively, she may decide to undertake overly risky investments — sub-profit-maximizing — because her options will only be valuable if the company enjoys a very large payoff. Given the undesirability of either of these incentives, repricing underwater options may be a rational adjustment. Yet this consideration raises a more fundamental issue. If an executive knows that it is rational for a firm to reprice underwater options, the incentive effect of the options may be attenuated; if the firm is successful, the manager will be paid off at the current option price, but if the firm is unsuccessful, the manager will eventually be paid off at an adjusted price. Commitment problems may thus exist for a firm that offers options as incentives to executives.

A different area of study might be the role of institutional investors. Although many people claim that such investors have suboptimal incentives to monitor compensation since each individual can reap only a fraction of the total gains from diligent monitoring, nevertheless such monitoring is observed. A possible explanation is reputation. For example, if the California Public Employees' Retire-

ment System — which is known for strict monitoring and negotiating over executive compensation in the United States — owns only 2 or 3 percent of one company's shares, its interest in monitoring appears trivial. Yet if, by challenging compensation in one company, it gains a reputation for monitoring compensation diligently, other companies in which it owns stock may be reluctant to grant excessive compensation packages.

Commentators frequent assert that increased disclosure of executive pay will encourage increased shareholder activism and more appropriate compensation schemes. Some suggest, however, that disclosure may in fact contribute to higher pay. John McNeil, chairman and CEO of Sun Life, states that his "informed opinion" is that "executive compensation levels in countries where disclosure is not required generally are significantly lower than in countries where disclosure is required" (1993, A33). An interesting area of study would be to examine the evidence on whether this opinion is true or not, and if it is, why. The previously described theory of the race to the top suggests that since no boards aim for below-average compensation, average executive compensation will rise from year to year. Disclosure may encourage this phenomenon.

The valuation of executive compensation also needs more study. There may be technical problems in assessing *ex ante* the value of some of the pay packages, especially those including stock options. Given that the options granted to executives are typically illiquid, it is difficult to determine their market-clearing price. The mathematical model frequently relied on to value these options, the Black-Scholes model, is very complex and would likely be inaccessible to many executives and shareholders attempting to value options. Furthermore, it requires variables, such as the volatility of the price of the stock on which the option is based, that are themselves difficult to estimate. There may also be problems with the model itself; in markets where options are traded, the price often deviates significantly from the Black-Scholes estimate.

Another area for further study is the effect of tax laws on executive compensation. Although the economics of compensation

suggests a variety of compensation tools to achieve a variety of objectives, tax laws may limit the choices. For example, if options are granted with the objective of inducing an executive eventually to purchase shares of the company and retain them, Canadian law may discourage this. When a Canadian taxpayer exercises an option, any gain potentially realized if the shares were sold is immediately imputed to taxable income, whether the shares are actually sold or not. Given that most people face some liquidity constraints, this law may encourage executives to sell the shares bought with options shortly after their exercise in order to realize the cash necessary to pay their taxes. Encouraging stock ownership through the granting of options may thus be discouraged.

Another issue arises with the tax treatment of supplemental executive retirement plans (SERPs), which are amounts paid to executives above the limit that the company can legally deduct as a pension expense for tax purposes. The promise of rich pensions may provide valuable incentives for an executive to remain loyal to a firm, yet the cap on pensions for tax purposes may obstruct such schemes. On the other hand, if self-dealing problems arise in the setting of SERPs, the fact that they are not deductible to the firm may exacerbate their harm to shareholders.

Although executive compensation has been the subject of considerable controversy, as this review has shown, the issues suggested here and others may present worthwhile topics for further study.

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