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Incentives And Inequality

A search for principles guiding executive compensation

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Increasing inequality is a serious challenge to social cohesion and stability (UNDESA, 2020). One of the most blatant examples for this is the considerable increase of executive compensation over the last decades. Since executive compensation as emerged at the beginning of the 20th century public controversy has haunted CEO salaries. Criticism mostly cites that it is too high or unfair – but when is it too high and when is it unfair? For anchoring the public sentiment in a more tangible and refined manner one can draw on the insights from economics, economic history, and philosophy. Together they provide three principles that can be ordered in a model of justification to guide the evaluation of executive compensation. Following these principles, it seems unlikely that current levels of pay are justifiable.

Evidence for practice

- Inequalities are inevitable and even necessary, but they should be seriously questioned given their implications for social cohesion;
- Equality of opportunity, an efficient principal-agent relationship and a fair distribution of social benefits are key to justifying executive compensation;
- Institutional settings that prevent back-door deals and nepotism and allow serious supervision by the affected parties when setting executive pay should be fostered.

Keywords: equality, executive compensation, incentives

Introduction

While workers' wages are stagnating, executive compensation has undergone an astonishing increase in the last few decades and catapulted itself back into critical public discourse (Wells, 2012) (see Figure 1). Should people earn a couple of hundred times more than the average worker and is compensation truly justified or even fair? CEO compensation has grown by 940% since 1978 while average worker compensation only increased by 12% (Mishel & Wolfe, 2019). Despite a voluminous history of regulation, executive compensation has never been regulated to a satisfactory end and continuously perpetuates economic inequality in advanced economies (Frydman, 2018). Every now and then striking cases of questionable compensation packages touch the surface and vast public outcry leads to regulatory activism. This cyclical approach has not remedied the problem (Murphy, 2012). Thus, this article seeks to extract principles that can guide the justification of executive compensation from the literature of economic history, economics, and philosophy. If applied vigorously, these principles will help revealing unjustifiable inequalities and rebalancing the distribution of economic benefits.

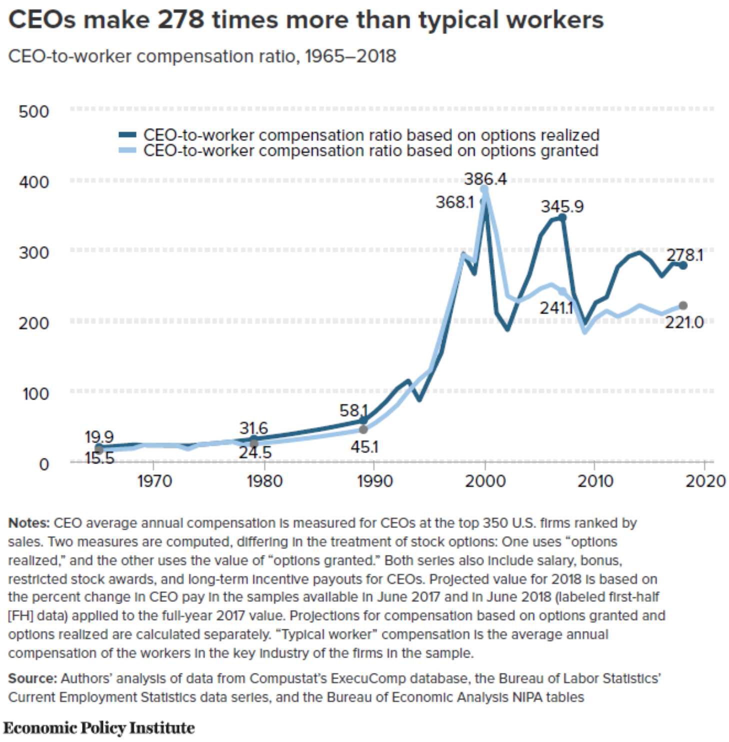

Figure 1 (Mishel & Wolfe, 2019)

Crash course on executive compensation

In their influential paper the economists Jensen and Meckling (1976) established executive compensation as a matter of agency theory. Executive compensation is consequently presented as a setting of differing interest between the principal, here the shareholders, and the agent, here the executive, in which a minimisation of necessary costs to align incentives is strived for. Even though this understanding is widely accepted, considerable dispute has emerged on how to characterise the current relationship between the principal and the agent. The 'markets perspective' stresses the adequacy of private authority for wealth creation and dismisses interventionist approaches based on their allegedly illegitimate interest in wealth redistribution. Meanwhile, the 'hierarchies perspective' pushes for more powerful incentives and stricter controls on executive pay because its proponents perceive executives as empowered actors lacking accountability (Bratton, 2012). Empirically, Yermack (1997) shows that stock options as part of executive compensation were often granted before good corporate news was published by the corporations.

On top of this, economic history has pointed out some distinctive features in the development of executive compensation which imply the relevance of constraining forces on executives. Essentially, executive compensation emerged at the beginning of the 20th century and increased considerably until the 1940. The growth rate slowed down for 30 years and has accelerated tremendously since 1970 (Wells, 2012) (see Figure 2). Especially the period between 1940 and 1946 is remarkable because average workers' wages grew faster than executive pay. Two reasons can be identified for that, namely the increased power of labour unions and a decrease of returns to firm size (Frydman & Molloy, 2012). Furthermore, it is slightly odd that one can observe the increase in compensation coinciding with the publication of Jensen and Meckling's paper. It might be that the concept of agency costs has been used to camouflage pay increases by exchanging common sense for just pay with a rationale that allows any level pay if it minimises agency costs. This falls in line with the argument of loosening social norms which fuel rising inequality (Piketty, 2014).

Figure 1: Median Compensation of CEOs and Other Top Officers from 1936 to 2005

Figure 1 shows the median level of total compensation in a sample of the three highest-paid officers in the largest 50 firms in 1940, 1960 and 1990 (for a total of 101 firms). Firms are selected according to total sales in 1960 and 1990, and according to market value in 1940. Compensation data is hand-collected for all available years from 1936 to 1992; the S&P ExecuComp database is used to extend the data to 2005 (Frydman & Saks 2010). Total compensation is composed of salary, bonuses, long-term bonus payments (including grants of restricted stock), and stock option grants (valued using Black-Scholes). The CEO is identified as the president of the company in firms where the CEO title is not used. "Other top officers" include any executives among the three highest paid who are not the CEO. All dollar values are in inflation-adjusted 2000 dollars.

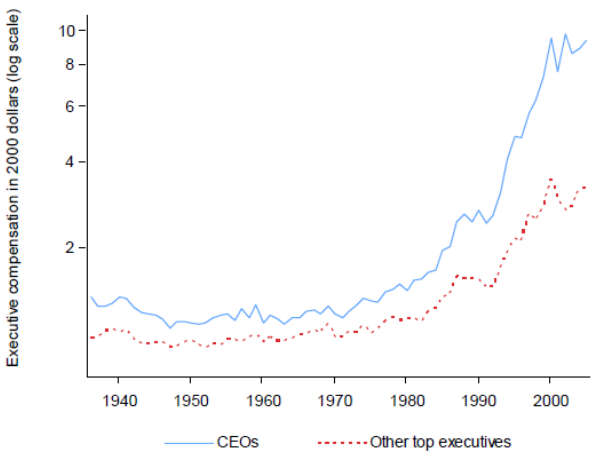

Figure 2 (Frydman & Jenter, 2010)

Going beyond economic theory

It should be clear that determining the acceptability of pay levels cannot only hinge upon the minimisation of agency costs. So, how should the concern for incentives and inequality be rebalanced in a progressive society? Despite popular critique, attacking executive compensation as too high is easily arbitrary because giving a satisfactory account of what levels of compensation in absolute or relative terms are acceptable is probably impossible and arbitrary (Harris, 2009).

At the foundation of the topic lies the 'incentives argument' which "contends that society justly permits those with special talents to receive extra, equality-undermining income, when doing so is necessary to entice them to apply themselves to certain tasks [...] they can do better than others." (Shaw, 2006, p. 87). The necessity for such arrangements in a market economy has been vigorously defended. However, the resulting inequalities, which are partly caused by the random distribution of natural endowments, must be limited to an acceptable level (Meadowcroft 2005). But how do we know whether pay is acceptable or not? Interestingly, all three main theories on distributive justice (Nozick,1974; Sen,1999; Rawls, 2005) stress the need for a just and fair process in setting executive pay (Harris, 2006).

Drawing on Rawls' second principle of justice, which splits up into the difference principle and principle of equality of opportunity (Rawls, 2005), one can outline two conditions. First, to satisfy the former, there needs to be a trickle-down effect and second, regarding the latter, it must be established that the executive position is truly open to everybody. The existence of revolving door practices (Shive & Forster, 2017) and back-door deals for setting executive compensation (Larcker et al, 2005) casts serious doubt on the openness of the executive position to all as well as on the fairness in determining pay. Moreover, even though many proponents of executive compensation argue that there is a trickle-down effect, the stagnation of average workers and the skyrocketing of executive compensation makes one question whether there is no other allocation possible to improve the position of the worst off.

Conclusion

If we want to move beyond an evaluation of compensation practices that disregards the social relevance of levels of income and its distribution, it appears sensible to integrate the philosophical arguments underpinning market-based allocations of renumeration into our understanding of justified pay. For that a model of justification can be designed (see Figure 3) which may guide further inquiries into the matter and rebalances the provision of incentives and development of inequality appropriately. In a nutshell, executive compensation must be the result of a fair and open process, it should minimise agency costs and there should be a trickle-down effect that reaches all parts of society. Ergo, what we need is not a free but a fair market. It is precisely in a free market where power structures unfold and easily undermine procedural justice. Those wishing to defend existing inequalities embodied by current levels of executive compensation are presented with a blueprint here which they, however, must live up to. It appears that such a defence would be a challenging task to say the least.

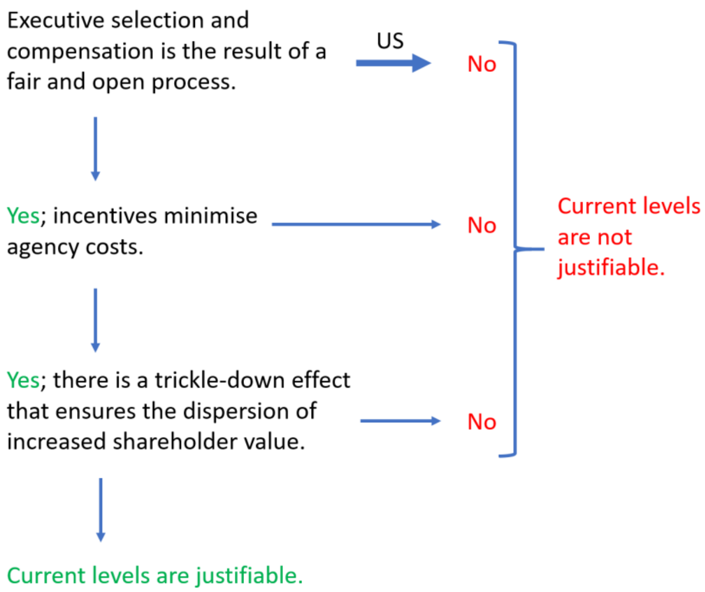

Figure 3 (author’s figure)

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A note from the author

My name is Jesse Magin and I am a bachelor student at Utrecht University. I am studying Philosophy, Politics and Economics with a focus on markets and regulators. Since I am very much interested in economic structures and the financial system in particular, what has always struck me were the fact that some executives were paid incredibly large salaries during the financial crisis in 2008 despite their rather subpar performance. Starting from this puzzling observation I arrived at the overarching question of why one would pay certain people a couple of hundred times more than the average worker in the first place. Crucially, it appears important to me to overcome the initial outrage about large compensation packages and ask how these can actually be justified and to what extent these justifications match up to reality.