A Moral and Economic Defense of Executive Compensation

Author(s): John Dobson

Source: *Business & Professional Ethics Journal*, 2011, Vol. 30, No. 1/2 (2011), pp. 59-70
Published by: Philosophy Documentation Center
Stable URL: https://www.jstor.org/stable/41340848

BUSINESS & PROFESSIONAL ETHICS JOURNAL, VOL. 30, NOS. 1–2

A Moral and Economic Defense of Executive Compensation

John Dobson

Abstract: A great deal has been written in recent years about the justification, if any, for the current levels of executive compensation. The folk consensus is that the current levels of executive compensation are unjustifiably high from both a moral and an economic perspective. In the case of the former, the compensation level is unfair and unjust. And in the case of the latter, the compensation level is not in the broader interests of other stakeholders or of firm-value maximization.

In this paper I counter this folk wisdom. I argue that executive compensation is a facet of the Stockholder Model, in which the primary objective of the firm is taken to be the maximization of shareholder wealth, and as such any moral critique of executive compensation is by default a critique of the Stockholder Model. Thus a necessary and sufficient condition for a moral defense of executive compensation is a moral defense of the Stockholder Model. I provide such a defense. Once the Stockholder Model is accepted then any moral or economic defense of executive compensation rests on its compatibility with shareholder wealth maximization. I argue that the current levels of executive compensation *are* consistent with the overarching corporate goal of shareholder wealth maximization. Thus the current levels of executive compensation are both morally and economically justified.

Key words: executive compensation, financial ethics, shareholder model

Correspondence may be sent to John Dobson (California Polytechnic State University), jdobson@calpoly.edu.

Introduction

The historically high levels of executive compensation (EC) have attracted much attention in recent years. A *Business Week* survey in 2003, for example, found that the average CEO in the United States earned total remuneration of about $8 million that year (Lavelle 2004). Furthermore, between 1991 and 2001 senior executive compensation in the U.S. increased by some 300 percent, while compensation for the average employee barely increased at all once inflation is taken into account (Byrne 2002). As Harris notes: "Data indicate that in approximately ten years, CEO pay jumped from about 100 times the pay of a typical worker in 1990 to somewhere between 350 and 570 times the pay of a typical worker" (2009, 148). He observes that "there is a widely held view in the court of public opinion that CEO pay packages are grossly exorbitant" (147).

I argue here that the court of public opinion is wrong. It has been misled by this type of 'sensational' statistic on both the absolute size of EC, and on the relative size of EC vis-à-vis the 'typical worker.' As regards the absolute level of EC, this is a highly volatile notional amount based on the valuation of stock and stock options. Furthermore, even if this valuation were accurate, only a tiny fraction of it could be actually realized by the executive at any point in time, or indeed over any reasonable period of time. Thus, to refer to this notional amount as 'pay' or 'compensation' is semantically misleading.

As regards the relative size of EC, this is entirely the result of the historically unprecedented rise in aggregate stock markets during the 1990s combined with the shift in the structure of EC toward stock and stock options. Thus a similar phenomenon can be observed in the 1990s with the broadening market-to-book ratios of corporate assets or price-to-earnings ratios; the broadening EC-to-average-pay ratio has no more significance than this. Furthermore, given the current market values of corporations that often climb into the tens or hundreds of billions of dollars, any CEO only has to add a fraction of a percentage to the value of his or her company to fully justify even the most generous EC package. For example, Apple Inc. is currently valued at about $300 billion, so if Steve Jobs's successor just adds one percent to this market value he or she will have contributed $3 billion to shareholder wealth!

From an economic perspective, therefore, it is not surprising that the numerous studies—discussed in more detail below—attempting to link pay to performance have yielded ambiguous results (Devers et al. 2007). By definition EC is a function of corporate market value, which in turn is a function primarily of broad market movements. Thus, at no fault of the executive(s) involved, EC may often diverge from actual own-firm performance given the vagaries of aggregate market averages.

In the case of the moral outrage aimed at EC, I again argue that this is misplaced. EC, as currently structured, is a reflection of what is generally termed the *Stockholder Model* (Jensen 2005; Danielson, Heck and Shaffer 2005). This model in essence posits that the primary measure of the success of executive activity should be the extent to which that activity contributes to the long-run market value of the company (often abbreviated as shareholder-wealth-maximization or SWM). Thus any substantive moral critique of EC is really at its ontological core a critique of SWM. So, assuming a given EC structure contributes to SWM, then to argue that said EC is unjust or unfair is at root to argue that SWM is morally unjust or unfair. Below I summarize a moral defense of SWM that therefore by default provides a moral defense of EC, assuming the latter financially contributes to the former. I then support this assumption with a summary of economic evidence connecting EC to SWM.

The Myth of Executive 'Pay'

Two common definitions of money are that it serves as a medium of exchange, or as a store of value. The majority of contemporary executive 'pay' provides neither of these functions. The stock and stock options that now provide the vast bulk of EC cannot be easily liquidated and so do not provide a medium of exchange; nor are they a reliable store of value given the vicissitudes of securities markets. So clearly, when considering any broader financial impact of contemporary EC, the type of 'money' this compensation represents should be of critical interest.

Up until the 1980s the majority of EC came in the form of salary (Jensen and Murphy, 1990). However, this changed dramatically in the 1990s with the acceptance of an agency-theory (Jensen and Meckling 1976) view of the firm and the concomitant perceived need to incentivise EC. This incentivising took the form primarily of stock options: "Almost 80% of the gain in executive compensation during the past decade has come from stock options" (Perel 2003, 155). For example, by averaging data on CEO compensation from over 1,000 firms from 1997 to 2002, Harris and Bromily (2007) find that actual salary awards in a given year averaged around $500,000; various performance-linked bonus awards averaged around $400,000; whereas the notional amount of stock and option grants over a similar period averaged around $5,000,000. But this

$5,000,000 figure must be carefully interpreted. This is not, in any meaningful sense money that the CEO can spend, i.e., it is not a medium of exchange. Most of these option and stock grants are 'restricted' by both internal compensation statutes and by various Securities and Exchange Commission (SEC) provisions (Devers et al. 2007). Even if a given CEO can legally liquidate his or her stock and option holdings at any point in time, there is ample evidence that the vast majority do not (Hall and Liebman 1998; Devers et al. 2007). For example, in an Annual Letter to Shareholders, Warren Buffett remarks: "I will keep well over 99 percent of my net worth in Berkshire [Hathaway Inc.]. My wife and I have never sold a share nor do we intend to" (2001).

In addition, even if the CEO could liquidate this $5,000,000 'compensation' the value realized would likely be a tiny fraction of this notional amount. Because these options are issued by compensation committees as incentives they are typically issued significantly out of the money (i.e., the underlying stock price is less than the call option's exercise price). As Harris and Bromily note: "The value of stock options is nonlinear. The option brings no income to the holder at any [stock] value below the strike price" (2007, 362).

This stock and option portion of EC is also highly suspect as a store of value. As Harris and Bromily's data indicate, the variability in the value of these options both cross-sectionally between companies and over time for a specific company can be enormous. Cross-sectionally, the standard deviation is about $400,000,000. Basically, these options' notional amounts are valued based on predictions of future stock price growth that may or may not materialize:

> According to SEC regulations public firms may value stock option grants using either a standard growth model (at 5%, 10%, or both), or the Black-Scholes option pricing model. The 10% growth model calculates the projected future value of the stock options granted by assuming 10% compounded annual growth in stock price over the term of the option. (Harris and Bromily 2007, 365)

If the 10% assumed growth does not materialize then the future liquidation value of these options can be vastly overstated in SEC filings of compensation awards. Also, if aggregate stock prices are declining, whatever potential value these options could have accumulated can be quickly erased as stock prices fall. Indeed, in their extensive empirical study of EC, Hall and Liebman find that even when aggregate stock markets are relatively stable, many executives experience a decline in the real value of options and stock: "[in] a flat year for the stock market, about 24% of the CEOs in our sample actually lost money during the year" (1998, 681).

In summary, the concern over recent levels of EC is often expressed by comparisons with average worker pay, or the pay of other professionals such as army generals, doctors, and university presidents (Moriarty 2005, 175). However, as the above discussion shows, these comparisons tend to overlook the fact that the majority of this 'pay' in the case of business executives is not pay at all in any meaningful sense. Specifically, EC is not a *flow* of money from the firm to the executive, as is the case with the pay of army generals etc. Rather, EC represents a *stock* of estimated value based on the pricing of highly volatile stock options whose value in turn is hostage to the vicissitudes of the aggregate stock market. Furthermore, executives who are awarded these stock options or stock are severely restricted in terms of when they can exercise the options and/or liquidate their holdings of stock.

Thus, to state—as the *Business Week* article mentioned above did—that the average senior executive got 'paid' $8 million in any given year is clearly misleading. It would be more accurate to say that the average senior executive got paid about $500,000 in salary and was awarded promissory notes in the form of restricted stock and stock options that, in the past decade, were about as likely to decrease in value over the year (as the broad stock market declines) as they were to increase.

Finally, another notable divergence between the compensation of senior executives versus army generals or university presidents is length of tenure. CEOs currently hold their positions for an average of about 4 years (Devers et al. 2007). As *The Economist* magazine notes: "40% of new chief executives fail [i.e., are dismissed] within their first 18 months. Corporate bosses are departing with such frequency that if the length of their reign continues to fall at the current rate . . . by 2042 the average boss will be in office for less than a day" (2005, 59). So whatever EC package senior executives are awarded, they are unlikely to earn it for very long.

A Moral Defense of Executive Compensation

Not surprisingly, far more has been written about EC by economists and management scholars than by ethicists. Indeed, Moriarty goes so far as to claim that "the topic of executive compensation has been virtually ignored by philosophers" (2005, 257). Those few ethical studies of EC that do exist tend to fall into two camps. They either focus on a few major 'scandals' such as Enron or WorldCom, and try to extrapolate broad conclusions from these few extreme cases (Perel 2003; Dembinski et al. 2006; Brazelton and Ammons 2002). Or they dwell on the spurious comparison of EC versus average-worker pay, and thus fall victim to the *Myth of Executive 'Pay'* discussed in the previous section (Dash 2006; Harris 2009; Miller 2006; Swanson and Orlitsky 2006).

Probably the most philosophically grounded critique of EC to date is Moriarty (2005). He considers EC from the perspective of three broad theories of justice: market justice as a fair and open agreement on wages; justice as just reward for effort or skill; and justice as fair reward for present and future utility added to aggregate welfare. Predictably, Moriarty finds EC unjustified under all three notions of justice. However, he tends to oscillate between some absolute moral critique of EC based on a philosophy of justice; versus an instrumental critique of EC as not contributing to SWM. For example, in his conclusion, Moriarty states: "The evidence suggests . . . that CEOs do not deserve to make 301 times what workers make, and that paying CEOs $8 million per year does not maximize firm value" (Moriarty 2005, 272).

Since he fails to account for the semantic complexities discussed above of the headline-grapping $8 million, his absolute moral critique clearly falls victim to the *Myth of Executive 'Pay.'* But, more fundamentally, his moral critique ultimately rests with the validity of SWM. In short, Moriarty's oscillatory shift to critiquing EC as not maximizing SWM is actually an economic critique of EC, once SWM is accepted as morally justified.

Indeed, if we accept that SWM is morally justified as the 'best' form of corporate structure, as opposed to say state ownership or some form of stakeholder model (Freeman 1984), then a moral defense of EC collapses into an economic analysis of whether it contributes optimally to SWM. Thus, if we accept that SWM is an ethically sound form of corporate structure, then the pertinent moral and economic question vis-à-vis EC becomes: *Does EC contribute to SWM?* Before this question becomes a sufficient evaluation of EC, however, we must satisfactorily answer the underlying question: *Is SWM morally justified?*

Is SWM Morally Justified?

The idea that the primary objective of management should be to maximize shareholders' wealth (i.e., SWM) is a foundational concept that underlies the discipline of financial economics. Finance theories such as those relating to capital budgeting or capital structure are all built around this underlying premise. However, this principle is often challenged by those outside the discipline. These challenges are often gathered under the broad label of *Stakeholder Theory* (Freeman 1984; Sundaram and Inkpen 2004) which, as the name implies, argues for a greater role to be played by non-shareholder stakeholders (e.g., employees, customers, the community, etc.) in corporate decision-making.

A thorough analysis of the extensive and ongoing *stakeholder-versus-stockholder* debate clearly is beyond the remit of this article's focus on EC. However, suffice to say that moral defenses of SWM are easily found. For example, in their extensive weighing of SWM against various stakeholder-type alternatives, Sundaram and Inkpen conclude: "We believe that shareholder value as the [corporate] objective function will lead to decisions that enhance outcomes for multiple stakeholders" (2004, 360). Jensen reaches a similar conclusion:

> I offer a proposal to clarify what I believe is the proper relation between value maximization and stakeholder theory, which I call enlightened value maximization. [It] accepts maximization of the long run value of the firm as the criterion for making the requisite tradeoffs among its stakeholders. (2005, 235)

Jensen does not argue that the sole motivation for managers should be SWM. He believes managers "must be turned on by the vision or the strategy in the sense that it taps into some desire deep in the passions of human beings—for example, a desire to build the world's best automobile or to create a movie or play that will affect humans for centuries" (244). What Jensen does believe, however, is that the gauge of success of a corporation's managers is the extent to which their collective activities contribute to long-run firm value maximization.

Emphasis on the 'long-run' is often made in contemporary defenses of SWM in order to emphasize that any decisions managers might make primarily to 'pump up' short-term stock price is not optimal and not consistent with a true understanding of SWM. As Danielson, Heck, and Shaffer put it: "stakeholder theory provides little guidance about how to balance the interests of various stakeholder groups. . . . [But] corporate incentive structures should reward managers for maximizing a firm's value in the long run rather than increasing its stock price in the short term"

(2005, 56). This brings us back to the subject of EC. Even if we accept SWM as the above authors do, we should only accept the current levels and structures of EC—namely stock options as the primary component—if this contributes to SWM. If stock options, stock, and bonuses tend to drive managers to maximize short-run stock price at the expense of long-run firm value then this would be sufficient indictment, both from a moral and economic perspective, of current levels and structures of EC.

Does EC Contribute to SWM?

From our discussion above, the critical empirical question that emerges on EC is the extent to which the current levels and structure of EC contribute to shareholder wealth. There is ample evidence that EC does indeed contribute to SWM. For example, in a survey of the EC of over 5,000 senior executives from 1993 to 1996, Aggarwal and Samwick (1999) find that, on average, a $14.52 change in CEO compensation leads to an approximately $1,000 change in shareholder wealth. In a more extensive follow-up study (2003) the same authors survey over 13,000 executives' pay from 1993 to 1997 and find similarly that, on average, about a $30 change in EC leads to a $1,000 change in shareholder wealth. Specifically with a focus on stock option awards, Hanlon, Rajgopal, and Shevlin (2003) find that these options do contribute to SWM: they find that $1 of option grant value (as estimated using the Black-Sholes option pricing model) is associated with about $3.71 of corporate income growth over the succeeding five years.

Another rigorous empirical study, this time on data outside the US, was conducted by Becker (2005). Becker employs data on CEOs of Swedish corporations. His three main variables are, first, the existing wealth levels of the CEOs independent of their wealth in the company for which they are CEO (this is used as a proxy for the individual CEO's degree of risk aversion); second, the compensation level of the CEO; and third, the concentration of ownership of the firm's stock (which is used as a proxy for the degree to which the CEO is able to exert power over the compensation decision). Becker finds that the CEOs who are already wealthier tend to be given compensation packages that are more closely linked to firm performance (e.g., options rather than salary). He also finds that neither the size nor the composition of the CEO's pay is related to the ownership concentration of the firm, which, to quote Becker "suggest[s] that wealth is not a measure of power (if wealth captured the ability of wealthy CEOs to skim corporate resources, the wealth-incentive relationship should be stronger in firms with less owner oversight and with a larger owner)" (12).

He concludes, therefore, that for his sample EC is indeed consistent with SWM: "the principal-agent explanation for these findings must be considered the most plausible" (13).

Of course the evidence does not always favor the current level and structure of EC. For example, Harris and Bromily (2007), find evidence that the powerful incentives engendered by high levels of executive stock options can lead managers to cheat via short-term financial misrepresentations. An extensive survey article by Devers et al. (2007) that summarizes over 100 academic studies of EC over the past 20 years concludes by noting "the mixed findings that pervade the field" (1042). They conclude that—

> The majority of recent work reviewed above demonstrates that the link between firm performance and executive compensation becomes more or less elusive, depending on the variables examined and the pay elements considered. . . . As a result, we expect criticisms regarding the efficacy of executive pay to achieve interest alignment to continue to plague compensation research and design until scholars more rigorously consider these issues in theoretical and empirical work. (1020 and 1042)

However, these 'mixed findings' are certainly not sufficient to support the vilification of EC often observed in the popular media (Lavelle 2004; Miller 2006). Indeed, in light of this mixed evidence, EC may be seen as a gamble on the part of shareholders that the CEO or other senior executives will increase firm value by just a few percent which, as noted above, would for an average Fortune-500 company represent hundreds of millions if not billions of dollars. Conversely, the downside of this gamble is small. As Hall and Liebman (1998) note:

> If annual CEO direct compensation were reduced to 42 percent of its current [1994] level (essentially back to 1980 levels) and the annual savings were returned to shareholders, shareholders in the median firm in our sample would receive an extra .04 percentage points of return in their shares. If the savings were spread equally among the firm's workers, the median per worker gain in our sample of firms would be $63 per year. (685)

So, from the shareholders' perspective, why not issue a new CEO generous option awards which have little immediate direct cost to the firm. But which could motivate the CEO to contribute billions of dollars to shareholder wealth in the future. As with the options themselves, it is a gamble with little downside but a potentially infinite upside.

Conclusion

A great deal of ink has been spilled in recent years debating the justification, if any, for the current levels of executive compensation. Much of the popular media argues that the current levels of executive compensation are unjustifiably high from both a moral and an economic perspective. In the case of the former, the compensation level is unfair and unjust. And in the case of the latter, the compensation level is not in the broader interests of other stakeholders or of firm-value maximization.

In this paper I argue that executive compensation is a facet of the Stockholder Model, in which the primary objective of the firm is taken to be the maximization of shareholder wealth. As such, any moral critique of executive compensation is by default a critique of the Stockholder Model. Thus a necessary and sufficient condition for a moral defense of executive compensation is a moral defense of the Stockholder Model.

I summarize economic arguments and evidence to the effect that the current levels of executive compensation *are* consistent with the overarching corporate goal of shareholder wealth maximization. Thus the current levels of executive compensation are both morally and economically justified.

References

Aggarwal, Rajesh K., and Andrew A. Samwick. 1999. "The Other Side of the Trade-Off: The Impact of Risk on Executive Compensation." *Journal of Political Economy* 107(1): 64–105.

———. 2003. "Executive Compensation, Strategic Competition, and Relative Performance Evaluation: Theory and Evidence." *The Journal of Finance* 54(6): 1999–2043.

Becker, Bo. 2005. "Wealth and Executive Compensation." *The Journal of Finance* 56(6):102–119.

Brazelton, Julia, and J. Ammons. 2002. *Enron and Beyond.* Chicago: CCH Inc.

Buffett, Warren. 2001. Annual Letter to Shareholders.

Byrne, J. A. 2002. "How to Fix Corporate Governance." *Business Week* (May 6): 68–75.

Danielson, Morris G., Jean L. Heck, and David R. Shaffer. 2005. "Shareholder Theory—How Opponents and Proponents *Both* Get it Wrong." *Journal of Applied Finance* 3(2): 45–58.

Dash, E. 2006. "Off to the Races Again, Leaving Many Behind." *The New York Times*, April 9.

Dembinski, Paul, C. Lager, A. Cornford, and J. Bonvin. 2006. *Enron and World Finance*. New York: Palgrave.

Devers, Cynthia E., A. A. Canella, G. P. Reilly, and M. Yoder. 2007. "Executive Compensation: A Multidisciplinary Review of Recent Developments." *Journal of Management* 33(6): 1016–1072.

The Economist. 2005. "Chief Executive Succession." May 7, 2005, 59.

Freeman, Edward. 1984. *Business Ethics: A Stakeholder Approach*. New York: W. W. Norton.

Hall, Brian J., and Jeffrey B. Liebman. 1998. "Are CEOs Really Paid Like Bureaucrats?." *The Quarterly Journal of Economics* 113(3): 653–691.

Hanlon, M, S. Rajgopal, and T. Shevlin, 2003, "Are Executive Stock Options Associated with Future Earnings." *Journal of Accounting and Economics* 36(1–3): 3–43.

Harris, Jared D. 2009. "What's Wrong with Executive Compensation." *Journal of Business Ethics* 85: 147–156.

Harris, Jared, and P. Bromily. 2007. "Incentives to Cheat: The Influence of Executive Compensation and Firm Performance on Financial Misrepresentation." *Organization Science* 18(3): 350–367.

Jensen, Michael C. 2005. "Value Maximization, Stakeholder Theory, and The Corporate Objective Function." *Business Ethics Quarterly*, 12(2): 235–256.

Jensen, Michael C., and William M. Meckling. 1976. "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure." *Journal of Financial Economics* 3: 305–360.

Jensen, Michael C., and Kevin J. Murphy. 1990. "Performance Pay and Top-Management Incentives." *Journal of Political Economy* 90(8): 225–264.

Lavelle, L. 2004. "Executive Pay" *Business Week* (April 19): 106–119.

Miller, M. 2006. "The Friendly Vulture." *Forbes* (October 9): 50.

Moriarty, Jeffrey. 2005. "Do CEOs Get Paid Too Much?" *Business Ethics Quarterly* 15(2): 257–282.

Perel, M. (2003). "An Ethical Perspective on CEO Compensation." *Journal of Business Ethics* 48(4): 381–391.

Sundaram, A., and A. Inkpen. 2004. "The Corporate Objective Revisited." *Organizational Science* 15(3): 350–363.

Swanson, D. L., and M. Orlitzky. 2006. "Executive Preference for Compensation Structure and Normative Myopia." In *The Ethics of Executive Compensation*. Edited by R. W. Kolb, 13–31. Malden, MA: Blackwell.