

## Trust the owners

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### *Companies need flexibility in choosing how much to pay their executives*

By Michel Kelly-Gagnon and Jasmin Gu nette

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Executive compensation has become a controversial issue in recent years. CEOs leaving office with large sums of money while the companies they led were in financial difficulties are regularly covered by the media and presented as proof of a problem. More recently, the economic crisis and government rescue of failing firms with public funds has justified imposing caps to executive pay. An internal managerial decision which traditionally was of relevance only to the administrators and shareholders of a given company is now being debated as a policy of interest to the general public

The debate centers on publicly traded companies whose day-to-day management is provided by executive managers hired by the board to run it on behalf of its numerous owners. It is one thing to realize that maximizing shareholder value must be the goal and another to identify the best means of reaching that goal. The main problem lies in the potential misalignment of incentives between shareholders and the executives who run their firm.

Fixing the level of executive remuneration represents a relatively simple problem, because this remuneration is in large part determined on the market for executives. A corporation cannot get a good executive if it does not pay the market price, and executives cannot get more than what colleagues with the same qualifications get.

An indication of the fierce market competitiveness is that some 40% of American CEOs are now hired from outside the company, a proportion that tripled over a few decades. Variable, incentive-based remuneration rewards executives for their performance. A review of the largest 1,088 companies in the U.S. showed that executives in companies that performed better were better rewarded. From 2005 to 2006, their profits on stock options increased 63% in companies with high returns and decreased 38% in those with low returns.

In Canada, a Hay Group annual study focusing on large cap Canadian corporations (S&P/TSX 60) has concluded that “[w]hile the correlation between pay and performance is relatively weak for the whole group, the results between the top/bottom 10 companies as well as the top 10 gainers/decliners tend to suggest that such a pay and performance relationship does exist.”

Incentive-based remuneration of corporate banking executives dates back at least to the 19th century. The phenomenon is thus not new. What has changed in recent years — and is likely at the roots of the current controversy — is that government interventions in compensation policies and in the broader economy are distorting the traditional market.

Theory and experience suggest that government cannot efficiently solve complex compensation problems. Sometimes, it artificially favours variable remuneration, as it did with the 1993

amendment to the Internal Revenue Code that eliminated corporate tax deductions for non-performance-based executive pay over \$1-million. At other times, bowing to other sorts of political pressures, it limits bonuses and encourages fixed remuneration, as we now observe.

Such limitations on performance pay will mean less incentive for executives, and less flexibility for adjusting remuneration to changing circumstances in the future. In fact, the U.S. government, which requires more executive pay disclosure than the governments of other countries, may well have contributed to executives obtaining higher compensation as they became aware of what their colleagues in other companies were earning. It is also likely that detailed and strict governance legislation like the Sarbanes-Oxley Act of 2002 add a risk premium to executive remuneration.

One solution that is being put forward to give shareholders more control over the remuneration of executives is the "say on pay" rule. It allows shareholders to have a direct say through a vote which is either binding or simply advisory, instead of leaving the matter entirely in the hands of the board of directors. In the U.S., Treasury Secretary Timothy Geithner has said that the Obama administration would like "say on pay" rules to be applied to all companies, not just those that have received bailout money from the government.

Since the shareholders of a firm are its owners, it is entirely legitimate for them to decide to have a direct say on the compensation packages of their executives if they do so through the appropriate voting procedure. Whatever impact, negative or positive, such a rule may have on the performance of the firm will be revealed through competition and will be sanctioned by market participants. However, imposing it to all corporations through law will prevent us from knowing if it helps solve the agency problem or not. It may simply distort the market even more, as other government interventions did before.

In 2005, according to U.S. Congress estimates, the median chief executive among 1,400 large companies earned \$13.5-million in total annual compensation. Although this looks like a lot of money, it relates only to large companies. Another way to put this amount in perspective is to note that the average National Basketball Association salary is almost \$6-million a year, or that lead actors routinely earn \$20-million for one film. But the latter rarely get criticized for this. The critics of the level of executive compensation often seem engaged more in a moral denunciation of capitalism than in a rational discourse about economic efficiency.

When, under pressure from those critics, governments try to replace supply and demand in setting remuneration by other arbitrary rules, they distort the most important mechanism by which firms can influence the choice of their executives and their overall governance structure. It is in the interests of shareholders to have efficient executive compensation. The best way for governments to allow shareholders to get the executives they want and pay them the optimal amounts is to stop interfering in the market process, not to add more interventions to those that already exist.

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