838 words

Compensation in Organizations: A Modest Proposal

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I think it is fair to say that we are approaching a crisis in capitalism similar to that at the end of the nineteenth century. At that time, major corporations were clearly being run for the benefit of their top managers (who were also usually their owners). The unparalleled greed by these beneficiaries led, in the near term to the trust-busting legislation of the first Roosevelt and in the longer term to the countervailing power of the Unions aided by the New Deal legislation of the second Roosevelt.

Since the 1970's, we have seen the repeal or non-enforcement of anti-trust legislation and we have seen the collapse of the labor movement as a viable countervailing force. As a consequence, the compensation of the executive echelon (and especially the CEO) has risen from 40 times that of the average employee in the 1970's to over 400 times that of the average employee today.

This change arises from two different trends: the inability of workers to capture much of the gains in productivity for themselves (this reduces the denominator in the CEO/employee pay ratio), and the practice of paying large bonuses (almost unrelated to performance; for example in the year that ATT lost $2.6 billion, the top management team gained $2.2 million in bonuses in addition to their regular salaries) to managers in order to attract or keep them in the firm. The collapse of union power has resulted in a Federal minimum wage that covers about 60% of poverty level wages for a family of four (a much lower percent in large, expensive urban centers such as Boston). The downsizing and outsourcing of the past decade has reduced the bargaining power of professional workers in the labor market. On the other hand, the labor market for CEO's has stayed rather strong – this, as pointed out by David Levin, is because it is a rigged market. Prices are set, not by free market forces, but by a firm's compensation committee which is often made up of other senior executives with an "arms length" relationship with the focal firm. They may be arms length in terms

of the firm's competitors, but they are anything but arms length in the CEO market. They too are players in that game, so higher compensation for one means higher compensation for all! There is a second way in which the market has been rigged over the past five years: fraud. All those phantom profits in Enron, Qwest, and so on had as a consequence not-so-phantom bonuses to their executives. To "compete" in this rigged market for executives, other firms had to raise their compensation levels at the CEO and executive level. Even after the bursting of the economic bubble, we see little decline in the compensation of executives (in the past three years, the total cash compensation of the CEO of ATT has doubled from $2.2 million to $4.8 million; while the stock price almost halved).

Over the past few years there have been attempts by stockholders to bring an end to excessive compensation, but this has been limited thus far in its success. What is needed is a change in climate, a change in the culture of best practice in organizations. The current culture since the downsizings of the late 1980's and early 1990's has been a view that top managers of a firm matter and that everyone else in the firm is dispensable. This attitude is exemplified by the enormous bonuses (in the range of 100%+ of salary) given to executives compared to the modest bonuses of 8% of salary given to employees.

In an organization, everyone makes a contribution to the success of the organization. That contribution is of course greater for the CEO than for the janitor, or even for the research scientist at her bench. These differences in contribution can and should be reflected in different salaries: a living wage for the janitor and a good differential for the research scientist, and a large differential for the CEO. But when it comes to the bonus awarded for the firm's performance, let equity reign. Let every member of the firm get the same percent bonus. Let everyone get 100% of salary or let everyone get 8% of salary. Reward differential contributions with different salary levels, but let the

bonuses be an equal percentage. If this were adopted as best practice by the best firms and by the powerful institutional shareholders, I believe that the excesses we see today would be banished. This is a stronger set of best practices than a simple goal to restrict CEO compensation as it provides clear links between CEO bonuses and employee bonuses. The adoption of such a best practice will not solve all of our problems with compensation excess. But it is a start that will, in turn, lead the looming crisis in capitalism to recede.