Strategic Management/Business Policy in a Catholic Business School

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Class # 4: Creating Value for Customers, Employees, "Owners" and Society – CEO Compensation

The question of executive compensation has received quite a bit of attention in recent years. Perhaps the most common reaction to executive pay is one of moral outrage. That outrage is fueled by the fact that executive pay as ballooned over the past 40 years. In 1980, executives earned perhaps 45 times more than the average worker; today the multiples are in the hundreds, with reports of ratios of 400 to 1, nearly 10 times the earlier ratios. This explosion of executive pay continues even after the Great Recession destroyed income and wealth for many. Students are likely to share this visceral outrage. But they are also likely to be exposed in some classes, particularly in Finance, to arguments defending high CEO compensation. If we are concerned to entice students into serious consideration of the CST perspective on business, it's important, then, to address both the standard defenses of executive pay and critiques of executive pay that might emanate from CST and secular views that share its understanding of corporate purpose.

Usually, defenses of executive pay arise in discussion of corporate governance. Traditional approaches to governance are mostly concerned with assuring that firms are managed and run in a way that assures optimal return to investors. That is, traditional approaches to governance presuppose the view that the purpose of the corporation is to create wealth for investors. Hence defenses of executive pay usually try to explain how current amounts and types of compensation are justified by increasing returns to shareholders. The growth in executive pay, in fact, followed the rise of the shareholder primacy model of corporate purpose and is an outgrowth of that model's concern for the agency problem: how can we assure that managers act not in their own interests but in the interests of shareholders? The solution was to make managers think more like investors by changing the mix of compensation from salary to performance bonuses and grants of stock options or restricted stock.

The current question from shareholder primacy perspective is whether current executive pay (both in its amount and in its composition) actually benefits shareholders. One view sees executive pay as the economically rational result of arms' length bargaining between potential executives and corporate boards. It argues that shareholders benefitted enormously during the period when executive pay was increasing due to large run-ups in stock prices. Steven Kaplan (2008) is a quite accessible example of such arguments.

The competing view sees executive pay as the result of undue managerial power and the ability of executives to capture the Board. (Bebchuk and Fried, 2004, provide a very readable version of this managerial power analysis.) This view suggests that executive pay has actually diluted shareholder value. It sees the rise in executive pay as the result merely of a generally increasing stock market combined with overly generous bonus and stock option grants. It claims that

executives reaped a windfall but not because of any special relative performance of their firms. John Bogle (2008), founder of the Vanguard funds, stated that real long-term company value increased only 1.2% once one accounts for the speculative return caused by an overvalued stock market. That, of course, is a much lower percentage than the percentage increase in executive pay. Lynn Stout's reading, referred to in the Note for Class #3 above, makes a similar case that current executive compensation practices have harmed shareholders by incentivizing risky corporate strategies that provide short-term return and benefit executives but damage the firm in the longer-term

This debate from within the shareholder value perspective should indicate to students that it is at best an open question whether the large executive compensation packages effectively create value for shareholders. While in theory it might make sense from a shareholder perspective to change the composition of executive pay to a more equity based formula, in actual historical practice, it is not so clear that even investors have benefitted from the last decades explosion in executive compensation. Even some of the most vocal past proponents of tying executive pay to stock price have recently begun to question whether that pay is more than needed to incentivize management to look after the interests of shareholders. (See Jensen, 2001.)

However, if we want to get students to entertain a broader approach to assessing executive pay, one that is consistent with CST's understanding of the purpose of business, we will have to show them how that perspective differs in its evaluation of CEO pay. The Teaching Notes for Classes 1-3 define strategic management as a process for creating value – but not only value for shareholders. If we accept the challenges to the dominant model of corporate purpose noted above from both CST and much contemporary management theory, the pursuit of value creation must include value for consumers, employees and society as well. And if we are to be true to the intent of both CST and the emerging paradigms of management, creating value for these other constituencies must not only be as an instrument for increasing shareholder value; creating value for these non-shareholders must be a fundamental and not merely an instrumental objective. Moreover, for CST, the value created for this expanded set of constituents cannot merely be assessed in the aggregate; instead, the value created must be such that it respects the dignity of the individual persons and protects their basic rights and interests.

CST has relatively little to say about executive pay in specifics. The following are some relevant passages (but these clearly give little precise guidance on the evaluation of specific pay packages).

> Catholic social teaching does not maintain that a flat, arithmetical equality of income and wealth is a demand of justice, but it does challenge economic arrangements that leave large numbers of people impoverished. Further, it sees extreme inequality as a threat to the solidarity of the human community, for great disparities lead to deep social divisions and conflict. (EJA, 70)

> Catholic social teaching does not require absolute equality in the distribution of income and wealth. Some degree of inequality is not only acceptable, but may be considered desirable for economic and social reasons, such as the need for incentives and the provision of greater rewards for greater risks. However, unequal distribution should be

> evaluated in terms of several moral principles we have enunciated: the priority of meeting the basic needs of the poor and the importance of increasing the level of participation by all members of society in the economic life of the nation. These norms establish a strong presumption against extreme inequality of income and wealth as long as there are poor, hungry, and homeless people in our midst. *They also suggest that extreme inequalities are detrimental to the development of social solidarity and community*. In view of these norms we find the disparities of income and wealth in the United States to be unacceptable. Justice requires that all members of our society work for economic, political, and social reforms that will decrease these inequities. (EJA, 185)

> But in determining what constitutes an appropriate wage, the following must necessarily be taken into account: first of all, *the contribution of individuals to the economic effort*; the economic state of the enterprises within which they work; the requirements of each community, especially as regards overall employment; finally, what concerns the common good of all peoples, namely, of the various States associated among themselves but differing in character and extent." (MM, 71)

> Remuneration for work should guarantee to individuals the capacity to provide a dignified livelihood for themselves and their family on the material social, cultural and spiritual level *corresponding to their roles and productivity*, having regard to the relevant economic factors in their employment and the common good (GS, 67)

> While the earnings of a minority are growing exponentially, so too is the gap separating the majority from the prosperity enjoyed by those happy few. This imbalance is the result of ideologies which defend the absolute autonomy of the marketplace and financial speculation. (EG, 56)

> They commit grave injustice who refuse to pay a just wage or who do not give it in due time and *in proportion to the work done*. (CSD, 302)

While these passages do not give determinate guidance, they are suggestive. There is clear dissatisfaction with the levels of inequality present in modern societies. There is also an implied concern about the relative amount of compensation received by executives. These suggestive paragraphs can be made somewhat more determinate with the assistance of more secular sources of critique. Executive pay is clearly an ethical issue. Secular philosophical approaches to ethical issues typically involve either an assessment through utilitarian theory or an assessment through notions of rights and fairness. (See McCall, 2010)

Executive pay can be questioned, as implied by the passages above, by asking about its consequences for aggregate welfare. To the degree that executive pay practices have encouraged management to under-invest in the future or to pursue short-term but risky strategy, those practices can be seen as a root cause of decreased social welfare.

Additionally, social conditions at the workplace, such as employee morale, have an impact on productivity and therefore on quantity of goods and services available to satisfy human need. Even the usually management-friendly Conference Board (2008) issued a taskforce report on executive compensation. In it, the taskforce called for serious reform in pay practices, including reform of multi-year employment contracts with generous severance, golden parachutes in case of change of control, pay "gross-ups" for taxes executives owe on their compensation, option repricing, and the like. The taskforce report said, "these . . . 'controversial pay practices'. . . may undermine employee morale, raise 'red flags' for investors, erode the company's credibility, and weaken the trust of key constituencies – —employees, shareholders, and the public." That even those who have been sympathetic are now calling for reform of pay practices suggests that those practices have been less than optimal for either shareholders in particular or for society generally.

The high levels of executive pay also exacerbate the growing inequality of advanced economies. If we believe in diminishing marginal return as a fact of human psychology, the unequal compensation will produce less aggregate happiness than will a less skewed distribution of wealth and income. Finally, as the paragraphs above suggest, inequality can be a source of social division and conflict. The inequality and the "winner take all" approach exhibited by current executive compensation can be corrosive of the social bonds necessary for the maintenance of a healthy, cohesive society. So, on secular, utilitarian grounds, students can be made to see questions about high CEO pay.

Executive pay can also be addressed on grounds of fairness. As some of the passages above suggest, the fairness of a distribution, when the goods distributed are the result of a cooperative endeavor, can be judged by the relative contribution the parties respectively made. Current levels of executive pay can thus be challenged as inappropriate remuneration for the executives' relative contribution. As John Bogle noted, there are serious questions about the role executives played in stock price appreciation. Pay did not seem to be based on relative performance but only on a broadly rising market. Further, it is far from clear that executives' contributions have in the past 40 years increased in proportion to their earnings, especially relative to ordinary workers. It is sometimes asserted that executive pay is compensation for increased job complexity and risk of job loss. However, ordinary workers have experienced increased job complexity and substantially increased risk of job loss as well - while gaining little in real wages over a 40-year period. Finally, the compensation of American executives can be compared to their less well-compensated international peers, who presumably have similarly complex jobs and, from the evidence, perhaps even higher risk of termination. Again the American executives relative compensation does not seem to be explained by greater contribution or risk. And since proportional contribution is a primary way to assess the fairness of a distribution, students can be made to see that there are also serious fairness questions about the level of current executive pay.

So, while the CST sources often do not make clear judgments about the ethics of current CEO pay, the broad concerns expressed there can be made more direct when supplemented by traditional secular ethical analysis.