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The escalating compensation of top corporate executives has been one of the most dramatic and visible sources of new individual wealth in recent years. Huge payments to CEOs often result from performance-based compensation plans, which are said to create incentives for managers to maximize shareholder returns, thereby harmonizing the interests of managers and investors. This chapter examines the practice of performance-based management compensation plans and explains why those plans rarely provide the intended incentives. The author is a business executive who served in the Treasury Department under the Bush administration; his book presents a broad critique of institutional factors that promote an excessively short-run orientation in corporate decision-making.

The Myth of Management Incentives

The system of connections and constraints that once guided corporate management has been seriously weakened, as top individual shareholders have come to exert less influence, deregulation has removed many traditional legislative requirements for corporate accountability, and relationships between banks and their corporate clients have grown more distant. [These changes are described in earlier chapters.] There is a need for new approaches to bring the interests of capital users into line with those of capital providers. Performance-based management compensation plans appear to be the most popular solution.

Academic analysts have found that executive compensation has very little relationship to corporate performance, and have suggested that making CEOs substantial owners of their own company's stock will lead them to maximize corporate values on behalf of stockholders in general. Yet despite the intuitive appeal of this argument, the evidence indicates that compensation systems are ineffective in achieving shareholders' objectives. Tinkering with compensation schemes is not the answer; "no management incentive system will unilaterally solve the problem of focusing corporate managers' attention on the long-run value of a business." (197)

There are three principal reasons for the failure of management incentive plans: performance-based pay is difficult to implement at levels below senior management; it is expensive to provide incentives big enough to affect the decision-making of CEOs who are already wealthy; and most existing incentives have side effects that promote unintended results.

Performance Pay Below the Top

The ideal performance-based compensation plan would meet several important criteria: it would rely on performance measures consistent with the goal of maximizing shareholder value; it would judge managers only on factors they can control; it would use simple, accurate, clearly defined, challenging standards, which are meaningful to the employee but not excessively expensive to the corporation. In practice, compensation plans typically fail to meet one or more of these criteria.

A critical problem is the definition of the appropriate measure of performance, especially for those below the top of the corporate hierarchy. Incentive plans frequently rely on accounting measures of profits, ignoring a manager's possible contributions to the firm's strategic position, market share, adoption of new technologies, or maintenance of employee morale – all of which contribute to long-run success and therefore are usually reflected in share prices.

An alternative to profit-based incentives, then, might be to tie everyone's pay to share prices. However, mid-level managers (let alone the employees below them) have very little control over either profits or share prices for the corporation as a whole. While they will be delighted with bonuses when the company does well, they will balk at compensation declines based on poor performance in other divisions. This problem has led to the abandonment of some of the most ambitious corporate pay-incentive schemes.

Pay Must Make a Difference

Top executives can reasonably be held responsible for the performance of the corporation as a whole. Yet at this level, it is expensive to provide incentives big enough to affect behavior. Those who have enjoyed six- or seven-figure incomes for years have by now bought anything they want, and may be unwilling to take risky or difficult initiatives simply to earn a little more.

The drive to link executive compensation to performance has led to pay packages with huge incentives for success, but usually without any downside for poor performance. Stock options, grants, and bonuses have simply been piled on top of already ample salaries. The result is ever-higher incomes, making it more expensive to obtain noticeable incentive effects in the future. International evidence suggests that U.S. executive compensation levels are not needed for effective corporate performance: as of 1989, top executives at the largest American corporations earned 109 times the average worker's pay; the comparable ratio in other leading industrial countries ranged from 17 in Japan to 35 in Britain, with Germany and France falling below the British level.

Pay Packages Can Have Unexpected Side Effects

Statistically, the correlation between incentive-based executive compensation plans and corporate performance is weak. This is in part because all the typical forms of incentive pay have deficiencies that can reward perverse behavior. Stock options, widely used in incentive plans, are a common example. The owner of stock options benefits only from increases in the stock price, while the stockholder benefits both from price increases and from dividend payments. Thus an executive compensated with stock options will favor reinvestment of profits to boost the stock price, even if a greater dividend payment would have maximized total return to shareholders.

Compensation that is insensitive to performance, or that rewards the wrong outcomes, can reflect the influence that top executives have over the determination of their own pay. Consultants who recommend executive compensation plans are almost always chosen by the CEO; the compensation committee of the board of directors, which approves pay packages, is frequently filled with the CEO's closest allies. Many so-called performance packages that emerge from this system are simply additional income. Cash bonuses are allegedly tied to year-end performance measures; in practice there is little rhyme or reason to bonus levels. In the year after the Exxon Valdez accident, when Exxon's net profit dropped by almost $2 billion, the salary and bonus of Exxon's CEO went up.

Stock options appear to offer, at least, a clear incentive to keep the value of the company's stock as high as possible. If the stock price falls below the fixed "strike price" of the option, then the option becomes worthless. However, boards of directors have been known to reissue options with lower strike prices when the value of the stock declines. Former Continental Airlines CEO Frank Lorenzo received options with a strike price of $29 per share; under his leadership the company's stock fell far below that level. Yet he still made money when he eventually sold his shares at $10 because the board had rewritten his options over the years, reaching a final strike price of less than $5.

An alternative is to provide direct grants of stock, sometimes with the restriction that it cannot be sold for a number of years, and is forfeited if the executive leaves the company during that period. Critics claim, however, that restricted stock grants, like options, provide rewards without risk; unlike ordinary stockholders, the recipient does not have any of his own money at stake. Yet requiring an executive to invest much of his own money in the company's stock would leave him with a very undiversified and risky portfolio, and would likely be unworkable.

While the benefits of incentive pay schemes are elusive, the costs are real, if somewhat hidden. Both stock grants and options are methods of providing generous executive compensation without any apparent cost to the company. The hidden cost is the dilution of other stockholders' equity, through the reduction in earnings per share that occurs when the number of shares increases.

Costs to stockholders are even more serious with another common incentive, "golden parachutes" that guarantee large cash payments to executives if there is a change in control of the company. The companies most vulnerable to takeovers are underperformers. Thus golden parachutes eliminate one of the primary risks of poor performance – executives with golden parachutes need not fear job loss due to a hostile takeover. Golden parachutes may even provide a perverse incentive for executives nearing retirement age to encourage takeovers.

In conclusion, "management pay is not an effective motivator. When it does work, it often motivates the wrong kind of behavior... [P]ay alone will never prove to be a substitute for effective accountability." (211-212)