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Pay Fairness: An Ethical or a Legal Issue?

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Pay Fairness: An Ethical or a Legal Issue?
By David J. Cherrington
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There is an interesting drama that has been playing in the United States for the past century called "*Executive Pay, Starring Your Local CEO*". For many years this drama was a *comedy* as executive bonuses and stock options continued to rise at ridiculous rates compared to the pay of factory workers, teachers, and engineers. This drama didn't get a lot of laughs; but people would smile and shake their heads as if the surprise was an amusing disclosure.

Our response to this drama contains an important lesson in morality for all of us. Should we rely on legislation to correct problems or should we act collectively to make ethical decisions? After careful thought, it becomes clear that legislation is a seductive copout that makes matters worse and detracts from our obligation to accept accountability for our individual and collective decisions.

During the 1990s, Congress thought it had the power to rein in rampant pay increases. It capped the amount of pay that can be treated as a pre-tax expense at $1 million, **unless** the additional compensation was based on performance measures. Quickly our drama became a *soap opera* as executives and their boards manipulated performance targets, granted additional options, and backdated stock options to perpetuate ever-increasing executive pay.

Dozens of executives and their compensation committees were shocked to see the vigor with which executives were prosecuted for simply altering the date of their stock options by a few days to increase the value of the grant. More that a dozen dozen have been accused of such manipulations and most of them either resigned under pressure or were terminated in disgrace.

On one hand, their punishments were just – they should have known the law and obeyed it. But, on the other hand, if their boards wanted them to get more money they could have simply granted more shares or manipulated the requirements in other ways to get around the problem. At any rate, the soap opera continued with ever-escalating pay levels plus criminal sanctions and a cadre of inspectors and prosecutors.

Something we should learn from this soap opera is that federal regulations are neither effective nor efficient. Compensation needs to be viewed as a moral issue that needs to be guided by ethical criteria rather than legal constraints. People who are smart enough to run our corporations are smart enough to subvert legislation restricting their pay.

Within the past few weeks, our executive-pay drama has turned into a *tragedy* as the 2009 stimulus law prohibits any company that receives a federal bailout from paying bonuses to top earners. Bonuses may not equal more than one-third of their total annual compensation. This restriction will severely impact top officials in the financial services industry where they have become accustomed to receiving millions of dollars in bonuses, and some even more than a hundred million dollars. Now, an employee earning $1 million pay can receive a bonus of no more than $500,000, which is one third of $1.5 million total pay.

It will be interesting to see how the new law is administered and how public pressure impacts the interpretation of the new restrictions. It will be even more interesting to see whether executive pay returns to reasonable levels or continues to escalate. But, lost in this debate is any discussion regarding the morality of executive pay and what ethical standards should be used to make pay decisions.

Why should the pay packages in the financial services industry be so much greater than wages in the retail industry? Does anyone appreciate how much money must be invested at a given interest rate to generate a $10 million bonus for just one person? Do board members appreciate how many autos must be sold on narrow profit margins to cover the cost of an auto executive's stock grant?

Across the board, we need to discuss a new paradigm for deciding executive pay; and we need to address it as an ethical issue rather than a legal problem. Hopefully, compensation committees will begin to recognize that enormous pay packages are outrageous and immoral – they destroy the viability of companies and society and they are blatantly unfair relative to others.

I propose the following pay maxim (ethical guideline), not just for executives but for all employees: *employees should be compensated first according to the requirements of the jobs they perform and how well they perform them, and second by labor market conditions (supply and demand) and the organization's ability to pay.* Obviously, this guideline is not precise; it requires judgment and experience to implement. But, all managerial decisions are moral decisions that require judgment and skill.

The greatest obstacle to deciding what is "fair" is the absence of a clear standard for making pay decisions. There are no universal standards or formulas for calculating how much money an employee deserves. When we examine how much people earn, the range of pay is so widely dispersed that there seems to be no semblance of order. In frustration, many people conclude that pay is random and depends simply on whatever each worker can negotiate. But this is not the case.

When we segment the labor market, we discover that there are legitimate criteria that ought to be used to make pay decisions. One labor-market segment is the blue-collar and non-supervisory white collar workers. These are the people who work in the offices, stores, and factories of America and they are typically paid on an hourly wage rate with no bonuses or stock options. Their pay is determined by such compensable factors as mental and physical demands, knowledge and skill requirements, and working conditions. In spite of a few exceptions, wage surveys indicate that most of the workers in this labor segment receive wages that seem quite legitimate.

Another labor-market segment consists of professional employees, such as teachers, engineers, chemists, and doctors. These workers typically receive an annual salary that is based primarily on the amount of knowledge and education required to certify as a professional. Their pay increases with years of service since experience is seen as an important predictor of ability and performance. Again, wage surveys provide useful data showing what professional employees ought to be paid and their compensation can be justified by legitimate criteria.

Professional athletes, entertainers, and entrepreneurs form a third labor segment and their incomes are extremely diverse and frequently criticized. Some receive little more than minimum wage while most receive millions of dollars for only a few hours work. The compensation of this group is not based on job-related compensable factors like the previous segments, but on the laws of supply and demand. If two people can convince a million people to pay $100 each to watch them put on gloves and bash each other in the face, they can split $100 million dollars. Anyone who makes a CD and sells it to a million listeners for a ten dollar profit will earn $10 million dollars. People who are outraged by the incomes of these people should think twice before seeing their movies or attending their concerts and games.

Executives and managers form the next segment of the labor market and this is where our ethical standards generally crumble with respect to compensation. The pay of this group ought to be determined by the requirements of the job (such as level of responsibility, number of people supervised, and number of levels in the company); how well they are performing (as reflected by the long-term profitability of the company); the uniqueness of the person's contribution to the company's success; and the profitability of the company. Instead, executive pay is determined more by sources of power than by rational compensable factors.

Executive pay is set by the board of directors, which sounds quite rational except for the fact that pay recommendations are made by compensation committee comprised of other executives who are equally overpaid. These pay recommendations are biased by comparisons with other executives and foolish myths.

One myth is the idea that every executive deserves to be paid above average, something every good statistician knows is statistically impossible. A second myth is that executive pay should be comparable to the pay of professional athletes, entertainers, and entrepreneurs, although there are no good reasons for such comparisons. Another myth is that executives are indispensable and could never be replaced by anyone else, something that history and experience fails to support. Rather than offering lavish bonuses, humongous stock options, and enormous retention packages, boards ought to pay reasonable amounts and be prepared to wish them well if they choose to leave.

As a society, we need a new paradigm for deciding executive pay that is based on ethical criteria rather than legislative restrictions. Fairness needs to replace greed as our basic criteria for creating pay packages.