Reflections on CEO Compensation

Through the Lens of Shalom and Justice

Kimberly M Sawers *reveals the latest facts about CEO pay and the widening gap between this and median corporate pay, which cause surprise and dismay to many. She points out the fundamental assumptions and ideology that underlie CEO incentives: agency theory, maximizing shareholder value and the free market. She offers an alternative approach based on the Christian concepts of shalom and justice, and makes some practical suggestions.*

Introduction

Chief Executive Officer (CEO) compensation in the U.S. has grown from a CEO-to-worker pay ratio of 30:1 in 1989 to 331:1 in 2014[1]. In response, the Securities and Exchange Commission (SEC) issued a rule on CEO pay disclosures as mandated by the Dodd-Frank Act. Among other things, the rule requires public corporations to disclose a ratio of annual compensation of the CEO to the median of the annual total compensation of all employees. The purpose of the rule was to heighten awareness of executive compensation and encourage shareholder engagement. In addition, increased disclosure was intended to highlight the need to create a long-term rather than short-term perspective, reduce incentives for short-term gain that benefit executives

Marc Lore is the President and Chief Executive Officer of Walmart eCommerce U.S. In the year 2016, Wal-Mart Stores Inc paid him approximately $236,896,190 thus making him the highest paid CEO of this world.

Photo: Fortune magazine

Lehmann Brothers collapse 2008

"the concern is that CEO incentive systems contributed to the excessive risk takings that led up to the 2008 financial crisis"

AP Photo/ Louis Lanzano

at the expense of its shareholders, discourage pay practices that led to the 2008 financial crisis, reduce the inequitable wealth distribution in the U.S., and curb the trend of excessive CEO pay.

The issue of CEO pay is not just isolated to the U.S. For example, in 2015 CEOs in the U.K.'s FTSE 100 earned 129 times more that their average employee, up from 47:1 in 1998[2]. Given the global nature of the economy, large multinational corporations around the world compete for the same CEO talent thus creating a perceived need to match high CEO wages. While the pay ratio in the U.K. is not as high as that in the U.S., the U.K. has already taken steps to curb excessive CEO pay by requiring publicly listed companies to publish CEO pay ratios by June 2018.

If we agree that the current state of executive pay is a concern, how do we enter this conversation as a Christian community? Higginson and Clough (2010) argue for a Christian framework for executive pay, which includes a concern for the poor, advocates a just pay, shows awareness of the dangers of wealth, and returns to the concept of stewardship, where CEOs are concerned with reasonable long-term growth that benefits all stakeholders, not just shareholders[3]. These concepts are consistent with some of the concerns expressed in the SEC rule on CEO pay disclosure requirements. One concern, however, about the CEO pay-ratio disclosure requirement is whether disclosures alone will be effective in curbing excessive CEO pay. One way to examine this question is to look at the underlying assumptions that influence how we compensate CEOs. I argue in this paper that our current CEO pay systems are, in part, a product of our underlying economic theories and assumptions. These assumptions lead to the creation of organisational structures and systems like CEO compensation schemes which in turn influence CEO behaviour. As a result, we need to examine those underlying beliefs and assumptions and ask if there is an alternative Christian perspective that may help transform the way we think about CEO pay and help restore justice. Specifically, I will look at CEO compensation through the lens of Shalom and Justice.

History

The concerns regarding CEO pay are not only how much they are paid, but also how compensation is determined - the compensation components (i.e., salary, bonus, stock options) and the incentive mechanisms in the compensation plan. Specifically, the concern is that CEO incentive systems contributed to the excessive risk takings that led up to the 2008 financial crisis. Another concern is the CEO-to-worker pay ratio as an indicator of the growing wage gap between the highest paid and the median employee. This wage gap is of concern from both an economic as well as a social justice perspective. Economically it is not sustainable and may preclude long-term growth in firm value. For example, there is concern that the CEO compensation plans provide incentives to manage earnings, take excessive risk and take actions that shift resources away from productive assets (e.g. stock repurchase to boost share price). From a social justice perspective, wage inequity and growing gaps between the very wealthy and the lowest income earners lead to social unrest and can lead to the emergence of radicalised political ideology.

So how does CEO pay contribute to this growing wage and wealth gap? Not only has CEO pay increased, it appears that CEOs are garnering a greater share of economic improvements. For example, between 1948 and 1973, productivity and hourly compensation for the typical worker grew at similar rates, 96.7%

and 91.3% respectively. This data indicates that as productivity increased, workers shared proportionately in the productivity gains. However, between 1973 and 2013 productivity grew 74.4% while hourly compensation only grew 9.2% (those at the lowest 10th percentile actually saw a 5% decline in average wages)[4]. Clearly, there were economic gains occurring during that time-period (1973-2013); however, the average worker no longer shared in those gains. So who did benefit? From 1978 to 2014 the Standard & Poor 500 Index grew 503% indicating that stockholders were receiving a significant portion of the productivity gains as reflected in stock prices. During the same time, however, CEO pay increased 997.2%[5]. Based on this data, it appears that CEOs garnered the greatest share of the productivity gains during this time-period. CEO pay and wealth from stock holdings increased while average wages stayed relatively flat or at the lowest pay level decreased. This is not simply a U.S. phenomenon. According to McKinsey Global Institute, two-thirds of households in 25 advanced economies have experienced flat-or-falling-income[6]. The report also describes a systematic decoupling of wages relative to productivity gains. Given these trends, it is easy to see how the average worker may feel disadvantaged.

Beliefs and Assumptions

When I ask my students what they think about CEOs and CEO pay, they say that CEOs are extraordinary people who work extremely hard, have lots of responsibility and take on a lot of risk for a wide variety of stakeholders. They also believe that there is a market for CEO talent and to attract and retain CEOs with the highest skills, abilities and education firms must pay the going rate even if exorbitant. Finally, they believe that there is a link between CEO talent and corporate performance. As a result, they believe that CEOs should be paid well but are not sure how well and generally underestimate how much CEOs actually make. These beliefs tend to mirror those of the public. Larcker, Donatiello, and Tayan (2016) surveyed average Americans to determine public perceptions of CEO compensation for the largest 500 US companies[7]. They found that the average American grossly underestimated how much CEOs make. Even though survey participants underestimated how much CEOs were paid, the respondents believed that CEOs were overpaid relative to the average worker and that CEO pay was a problem. Further, survey respondents thought the maximum CEO pay to average worker should be close to 18:1 (actual average CEO ratio in 2017 was 391:1). While Americans agreed there is a problem, they were split on whether government should get involved.

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Common beliefs about CEOs and a lack of general understanding of the magnitude of the problem make it difficult to determine the best way to resolve the issues of CEO pay. In addition, there are basic economic and market assumptions that contribute to how CEO compensation packages are created. The fundamental assumptions that underlie CEO incentives are agency theory (individuals are rational decision makers and utility maximisers), the primacy of maximising shareholder value, and the free market hypothesis. I will look at each in turn.

Agency theory

> *We define an agency relationship as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. If both parties to the relationship are utility maximizers, there is a good reason to believe that the agent will not always act in the best interest of the principal.*
> (Jensen and Meckling, 1976)[8]

This theory assumes that humans are rational decision makers and utility maximisers (i.e., they maximise their own personal utility or self-interest). Thus, agents (CEOs) will act in a way that advances their own personal interests, rather than the interests of the principal (stock or shareholders). This is the fundamental agency problem. To overcome the agency problem, the principal can either *monitor* the agent to make sure they are complying with the principal's wishes or design an *incentive system* to align the goals of the agent with those of the principal. In the modern corporate structure, monitoring activities are costly and unmanageable for the typical principal. Corporations are too large and diverse with ownership that is too distant and diffused. Given the problematic nature of monitoring, the primary solution to the agency problem used in US firms is incentive systems.

While agency theory is a dominant economic assumption that is fundamental in the rationale for the creation of CEO compensation plans, the theory is not without its detractors. The emergence of behavioural research in economics, accounting and finance has questioned the concept that humans are purely rational decision makers. Findings indicate that humans suffer from cognitive biases, respond to framing, are susceptible to social dynamics, and are affected by emotions when making economic decisions[9]. All of these lead to decision outcomes that do not meet the strict definition of rational decisions. In addition, others argue that the theory that humans are utility maximisers is self-referencing, circular, and, as a result, can be used to justify anything. The assumption that CEOs are self-interested utility maximisers who will only perform if given incentive systems that play on their self-interest is a rather unflattering characterisation of human nature. Some critics would also argue that people do not always act consistently with this perspective. For example, individuals do not always maximise their own wealth but rather prefer truth telling and fairness considerations as well as reputation and ethical concerns[10].

Maximisation of Shareholder Wealth

Maximising shareholder wealth has become the predominant goal of US corporations since the 1980s. However, maximising shareholder wealth assumes that companies know who the shareholders are, that the shareholder is the only stakeholder that risks an investment and the only one that matters. Markets have become increasingly financialised (i.e., exchange is facilitated through the intermediation of financial instruments), making the relationship between the individual investor and the company even more distant and diffused. This all begs the question who is the 'owner' and what do they really want? Further, given the diffused nature of shareholders and the stock-based pay included in CEO compensation plans, are CEOs focused on share price on behalf of the shareholders or themselves?

Free Market

The free market assumption asserts that markets work best when the prices of goods and services are freely set by consenting parties based on supply and demand and are free from government intervention. Thus, there is a market for CEOs driven by supply and demand and, as a result, companies must provide a high level of compensation to attract and retain talented CEOs. This assumes a link between pay and performance. It also assumes that any government intervention, like capping CEO pay, would work against the efficiency of a free market system.

In summary, ideology and assumptions influence the creation of structures. Specifically, agency theory, maximising stockholder equity, and free-market assumptions, have influenced how we structure incentive systems and ultimately behaviour. The problem is that we have reached the point where these structures have created significant inequity. Milton Friedman advocated the ideology that the maximisation of shareholder wealth is the greatest and only social good for a corporation. This assumes that if business and the market are doing well, everyone in society will do well. However, that is not what we have seen. There have been those who have achieved great gains like the CEOs and shareholders, and those who have seen very little to no gains like average workers, with some who find themselves worse off like the lowest 10th percentile of wage earners. Further, the gains achieved by the top appear to have been gained at the expense of the rest.

How do we then as Christians think about this issue of excessive CEO compensation and the growing wage gap? I have argued that ideology and assumptions can influence structures and structures can influence behaviour. In that case, are there other ideologies, theories and assumptions that might help us look at structures like incentive systems? How might we create structures that are more aligned with shalom and justice, that contribute to our redemptive work and to human flourishing?

Theological Concepts

Before I explore the topics of shalom and justice, I would like to set the stage. I take a formative perspective that looks forward to salvation from a fallen world and actively seeks its reformation, a desire to bring reality closer to the will of God. The primary motivation for this transformation is gratitude for all that God has done for us. Thus, in return, we act as God's agents to move the kingdom of earth closer to the kingdom of God. All of our earthly institutions are social structures created by humankind. If human beings create structures, then they must be responsible for them. Further, if they are man-made, they can be amended and potentially redeemed. Wolterstorff (1983) argues that humankind's obligation is an obligation toward God to work toward creating structures that 'open-up' creation's potential[11]. These structures are manifested in institutions such as the state (government), the productive enterprise (economy/business), and family. Thus, our response as Christians should be to work for a balance of our structures so that there is an array of institutions that serve the lives of the members of society.

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A route into the economic ideal might be found in taking a look at the original word for economics, *Oikonomia*. The concept designated the behaviour of the steward whose task it was to manage the estate entrusted to a steward in such a way that it would continue to bear fruit

Transparency

Buffer employees at a team retreat in Reykjavik, Iceland.

Photo: Buffer

US Social media company *Buffer* publishes all its staff salaries on its website, including the 6-figure CEO salary

and thus provide a living for everyone who lived and worked on it. Central to this concept, therefore, was the maintenance of production assets on behalf of everyone involved. What we currently have, however, is more like *Chrematistike* - the pursuit of self-enrichment, for ever greater monetary possession, if need be at the expense of others. Thus, if we are to rebalance we need to move away from our *Chrematistike* state to one more resembling *Oikonomia*.

The definition of *Oikonomia* is also consistent with the concept of shalom.

> *Shalom is the human being dwelling at peace in all his or her relationships with God, with self, with fellows, with nature.* (Wolterstorff, 1983).
>
> *Shalom is the substance of the biblical vision of one community embracing all creation. It refers to all those resources and factors that make communal harmony joyous and effective.* (Brueggemann, 2001)[12].

These definitions create a picture of shalom that emphasises harmonious relationships and is even delighting in those relationships. What does it take to have harmonious relationships with God, with others and with nature? Shalom requires justice, focus on community, rights, responsibilities and duty.

> *Shalom is absent when a society is a collection of individuals all out to make their own way in the world. There can be delight in community only when justice reigns, only when human beings no longer oppress one another.* (Wolterstorff, 1983)

How does this vision of shalom and justice contribute to the issue of excessive CEO pay and CEO pay ratios? Shalom emphasises the need for developing relationships with God, with community and with creation. Excessive pay at the expense of others (community) and/or creation care is opposed to a state of shalom and justice. While our assumptions under agency theory are of self-interested, risk-averse agents, shalom advocates a sense of gratitude as a motivation for transformative action that is concerned with justice for the entire community and creation care. What would an incentive system look like that valued, encouraged and rewarded gratitude and stewardship; that encouraged all members to innovate and grow? A system where what is good for the company is also good for the CEO *and* average worker *and* community *and* creation. I acknowledge that choices and actions require, at times, balancing conflicting needs, but can we move to a system where we consider all these concerns as equally valid claims?

What if instead of solely focusing on maximising shareholder wealth we attempted to maximise community well-being? One place to start with community concerns is with the corporate board of directors. Improving board independence, inclusion of employee representation, increased transparency and more intentional interaction with both shareholders and other stakeholders would go a long way to begin the process. Further, what measures would be needed to ensure that CEOs paid attention to community? The CEO pay ratio is an indicator of both excessive pay at the CEO level but also care (or lack of care) for the company employees as a whole. Could we establish indicators that examine the well-being of the bottom of our organisation as well as the top? For example, the Living Wage Foundation in the U.K. works with companies to become Living Wage accredited, where all employees in the company earn a living wage (employees as well as those in the supply chain). Other indicators are also needed, such as those that relate to worker rights and value (e.g., training, medical benefits), fair wages for contractors, supplier relation and treatment, ethical practices, environmental practices and customer service. The good news is that these indicators already exist and are currently being used (e.g. for socially responsible investing or triple bottom line reporting). The key now is to make them part of CEO compensation plans.

Further, instead of focusing on the efficient market hypothesis, could we think more about the appropriate role of each sphere (e.g., economics, government, family)? Could we re-conceptualise the identity of each sphere, value the contribution of each and make sure they did not encroach on each other? What would the relationship between business and government look like? How would we change our thinking about social programmes – so that instead of thinking of charity or being generous, which connotes superior to inferior relationships, we think in terms of rights and duties afforded each other?

Using a lens of shalom and justice would encourage us to affirm the purpose of business as providing goods and services that contribute to human flourishing. It would also help us to create an understanding that all of the players 'risk' something when contributing gifts and talents to an enterprise. Concepts of shalom and justice emphasise both rights and duties. The duties of the CEO and Board under shalom would reintroduce the concept of their fiduciary responsibility. Finally, thinking about structures through the lens of shalom would help us create systems that are more just. For example, our incentive systems would encourage and measure what is valued under shalom (more than just increasing profit and stock price). If we are able to accomplish all that, it is unlikely we would see the type of pay gaps we see today.

Conclusion

This paper examines the underlying assumptions that influence CEO pay and seeks to introduce the biblical concepts of shalom and justice as an alternative way to think about structures and systems. The predominant economic assumptions of self-interested individuals and the primacy of maximising shareholder wealth have led to compensation schemes that have escalated CEO pay dramatically over the last 30 years. They have potentially led to myopic, short-term perspectives that are susceptible to excessive risk-taking and earnings-management. Alternatively, the concepts of shalom and justice move the focus to gratitude and transformation of institutions and structures whose goal is to be at peace with God, self, community and creation. A peace achieved through a focus on justice.

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4 Economic Policy Institute (EPI) analysis of Total Economic Productivity data from the Bureau of Labor Statistics (BLS).

5 EPI analysis of data from compustat's ExecuComp database, Federal Reserve Bank of St. Louis, the Current Employment Statistics program, and the Bureau of Economic Analysis NIPA tables, as seen in 'Top CEOs Make 300 Times More than Typical Workers.'

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8 Michael C. Jensen and William H. Meckling, 'Theory of the firm: managerial behavior, agency costs and ownership structure,' Journal of Financial Economics 3: Pp. 305-360.

9 For example, see: Amos Tversky, A., and Daniel Kahneman, 'The framing of decisions and the psychology of choice,' Science, New Series 211(4481): pp. 453-458.
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11 Nicholas Wolterstorff, *Until Justice and Peace Embrace*. William B. Eeerdmans Publishing Company, Grand Rapids, Michigan, 1983, pp. 65-80.

12 Walter Brueggemann, *Peace: Understanding Biblical Themes*, Chalice Press, St. Louis, Missouri, 2001, p. 14.

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