



## Free Enterprise: Executive compensation: Separating facts and fiction

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Kenneth R. Feinberg, the government's "special master for executive compensation," or "pay czar," got it right this week when he said: "I don't think government should be in the business of micromanaging compensation across the board in corporate America." He was also at pains to emphasize his governmental intrusion into the setting of fair market compensation was narrowly defined and cautiously applied.

The remaining question, then, is whether his announcement that the federal government will cap compensation for top executives at bailed-out firms, which have not paid back these funds, amounts to "micromanaging" or simply the proper exercise of stakeholder authority. This discussion occurs in the context of just-released proposals by the Federal Reserve "designed to ensure that the incentive compensation policies of banking organizations do not undermine" the banking system (available here: <http://tinyurl.com/yzxg8jq>).

Plainly, the public outrage over "unjust" compensation has had an effect and although Feinberg insists "there has been no political interference whatsoever," it would be naive to assume he is simply making decisions according to the law in a political vacuum.

In fact, the very existence of his position is due to public dissatisfaction with compensation practices.

There is nothing wrong with taking a critical look at compensation.

This "Free Enterprise" column, in January of 2007, advocated that "CEO pay: Great rewards should be earned." The economic argument was then, as it is today, that pay packages should not be independent of performance.

Many of the proposals by the Fed as well as some of the actions by the "pay czar" are clearly attempts to establish a strong connection between short-term earnings for executives and long-term creation of wealth for shareholders.

However, they should be targeted at institutional frameworks rather than individual salary packages.

What is really wrong with the whole debate about executive compensation abuses - as much as it has value in permitting one to vent anger at easy targets - is the revelation that it may be based on false perceptions.

This is the lesson from a careful academic study of executive compensation in the U.S. from 1993 to 2006, which was just released (and is available here: <http://tinyurl.com/yjerloe>).

New York University economists Gian Luca Clementi and Thomas Cooley analyzed "information on 31,587 executives, employed by 2,872 companies, for a total of 33,896 company-executive matches and 167,822 executive-year observations."

The results indicate that the public view of a broken link between pay and performance is inaccurate.

As the report notes, "much of the perception is based on a set of 'facts' that are not completely reflective of reality." The authors, using various ways to measure compensation, conclude that "the sensitivity of pay to performance is substantial."

This implies most CEO's earn their (very high) compensation by creating (high) value to shareholders.

Of course, that should not be taken as a carte blanche for CEO compensation practices.

A 1933 Supreme Court decision, cited in the study, states: "If a bonus payment has no relation to the value of services for which it is given, it is in reality a gift in part, and the majority stockholders have no power to give away corporate property against the protest of the minority."

Judge Thomas Walter Swan, the Second Circuit judge who wrote that sentence more than 70 years ago, got it right, too.

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