By Re_Generation

Business Ethics

3.3 Excessive Compensation

Description

Excessive executive compensation has been one of the central factors leading to increased income and wealth inequality in North America. Between 1965 and 2000, CEO compensation in the United States grew by about 2500%, while average worker compensation increased by only 30%. According to the High Pay Centre, the ratio of CEO pay to the wages of the average worker rose from 42 to 1 in 1980 to an astonishing **347 to 1 by the year 2017**. In Canada, executive compensation is at **one of its highest levels in history**. However, most research shows that the relationship between bonus increases and profit growth is **non-existent**, and that there is **no link** between long-term incentive plans and shareholder returns. At the same time, one study found that companies with higher CEO-to-average-worker pay gaps **perform worse than those with greater pay equity**. To find out what firms should be doing to advance pay equity and limit excessive executive compensation, continue reading this PDF guide.

Acknowledgements

Written by Gareth Gransaull, Associate Director of Re_Generation, with review by some of Canada and North America's most influential sustainability leaders.

About Re_Generation

Re_Generation is a Canadian youth movement that seeks to build a regenerative, sustainable, and just economy. We aim to reimagine our schools, repurpose our careers, and remodel our companies to be aligned with regenerative principles. In particular, we provide resources for individuals to launch impact-driven careers and advocate for change within their companies and schools. We also aim to advance public policies that promote regenerative and sustainable business practices.

Our successful 'Our Future, Our Business' Manifesto campaign received the support of 65 youth organizations, 130 high-level executives, and 100 civil society organizations recognizing the need for reform in business education on sustainability. After three years of existence as the Canadian Business Youth Council for Sustainable Development, we have changed our name to Re_Generation to become more inclusive of all youth, not just business youth.

We believe that the ideal society is a **regenerative** one. Regeneration to us means putting human and ecological **well-being** at the centre of every decision. It means restoring relationships, both within nature and within society, while helping all communities to thrive. Read more about our history and vision at our **About Us** page.

Issue Summary

Around the world, income and wealth inequality is reaching a historic peak. According to **Oxfam's 2020 report on inequality**, the world's richest 1% now has more than twice as much wealth as 90% of the world's population. In Canada alone, the top 1% own significantly more wealth than the bottom 70%, and the 87 wealthiest families own **as much wealth as the lowest-earning 12 million Canadians**.

Although there are many complex factors that lead to income and wealth polarization, such as globalization, automation, and de-unionization, one key contributor has been the staggering rise in executive pay over the last five decades. Between 1965 and 2000, CEO compensation in the United States grew by about **2500%**, while average worker compensation increased by only 30%. According to the High Pay Centre, the ratio of CEO pay to the wages of the average worker rose from 42 to 1 in 1980 to an astonishing **347 to 1 by the year 2017**. Considering this trend, it is no surprise that from 1980 to 2005, more than 80% of the total increase in Americans' incomes **went to the top 1% of earners**. In Canada, CEO pay is at **one of its highest levels in history**.

The dramatic rise in executive compensation is one component of a broader shift towards a **corporate governance regime focused on shareholder primacy**, a system that rewards an elite cadre of owners and managers at the expense of workers and other stakeholders. Leading conservative academics such as **Michael Jensen** influentially argued for executive compensation to be paid in stock in order to improve the alignment of interests between a firm's shareholders and its managers. Over time, stock-based compensation grew to account for **75% of the average CEO's compensation**, contributing to a '**tragedy of the horizons**' in which many executives choose to prioritize stock buybacks, dividends and other short-term profit-generating measures while neglecting long-term value creation and systemic risks like climate change.

This problem is so pervasive that an entire meta-industry known as **executive compensation consulting** has been created, operating under the unspoken premise that every year executives should be earning more than they did the year before. There is strong evidence that CEOs who employ executive compensation consultants **receive higher pay** than those who don't. Interestingly, however, there is no evidence that performance-based pay incentives, such as stock compensation, have any relationship to firm performance. One study found that the relationship between bonus increases and profit growth is **non-existent**, while another identified **no link** between long-term incentive plans and shareholder returns. Even more perversely, one study found that companies with higher CEO-to-average-worker pay gaps **perform worse than those with greater pay equity**, while research from Harvard Business School actually identified a negative relationship between firm performance and CEO compensation. It is very possible that these negative correlations are a result of the fact that an excessive managerial focus on short-term performance can **make companies less competitive in the long-run**, particularly by dampening spending on innovation and reducing other long-term strategic investments.

In an age of rampant social destabilization and political unrest, excessive executive compensation is increasingly being seen as **an issue of public concern**, one that significantly undermines private sector social impact goals. As reported in the Financial Times, at many large companies a $1 million reduction in CEO remuneration in 2020 would have **increased the pay of other employees by more than 10%**. There has also been public outrage over exorbitant executive pay in the face of widespread job losses due to the COVID-19 pandemic; many observers were outraged when the CEO of AMC Entertainment doubled his annual pay package to $20.9 million in a single year, at a time when 25,000 of AMC's staff had been furloughed. There is a growing body of evidence which demonstrates that economic inequality serves to increase **political polarization** and **raise poverty** while **reducing economic growth**,

contributing to poorer health outcomes, and undermining democratic participation. Countering inequality is critical to the achievement of global sustainable development goals, and combating excessive executive pay is a key lever of change.

Key Considerations

Although executive compensation is thought to be based on merit and tied to performance, in reality it is nothing of the sort. According to French economist Thomas Piketty, the situation has evolved such that "top managers by and large [have had] the power to set their own remuneration." Many large firms have compensation committees, typically composed of other highly paid executives, who calculate CEO based on a benchmark of peers. This peer list is supposedly chosen at random, but is often cherry-picked to include companies that are larger and have executives that are paid more. Because most firms are biased to assume their own managers are above-average, they will set pay rates to exceed this benchmark, and as a result executive pay continues to climb upwards year after year. Additionally, most board directors serve on each other's compensation committees, creating a quid pro quo environment in which escalating pay is the norm. Executive compensation consultants, meanwhile, are often bidding on other contracts with the same firms for whom they are determining executive pay. This problem is so pervasive that there is actually a positive correlation between CEO pay rates and the extent of a consultant's conflicts of interest.

On a comparative basis, companies that use compensation consultants end up disguising more of their pay in stock options and retirement deals, a strategy to shield their executives from tax liability or board scrutiny. By exercising forms of 'stealth compensation', such as generous retirement plans and stock-based performance measures, firms are able to obfuscate the terms of employment and make the real pay value appear more opaque. While performance-based pay is theoretically subject to shareholder approval, shareholder votes are purely advisory, and it is only in rare cases that they have overturned executive pay decisions.

There are many things a firm can do to improve pay equity, in particular by limiting the use of executive pay consultants, changing the structure of compensation committees, or imposing caps or limits on overall pay levels. Instead of using horizontal benchmarking relative to peers, firms should use **vertical benchmarking** in order to link executive pay to the pay structure of the company as a whole, most importantly by tying CEO pay to the pay of average workers. The High Pay Centre has developed a **list of proposals** for firms to crack down on excessive pay, which include:

1. Paying in cash rather than stock, and requiring executives to purchase shares with their own money;
2. Linking pay to non-financial targets (i.e. productivity levels, ESG and corporate purpose metrics) in order to limit the incentive for stock buybacks, short-term cost-cutting, or other forms of financial engineering;
3. Broaden the diversity of remuneration committees, and impose rules to reduce conflicts of interest created by interlocking compensation committees;
4. End 'golden hello' payments (i.e. generous introductory payments meant to attract high-performing managers) when recruiting for unadvertised positions.

To read more about living wage policies and ensuring a decent living for all employees, see Section 2.3 on labour rights and working conditions.

Tools

The main metric to determine if a company's executives are overpaid is the ratio of CEO compensation to the annual pay of the average worker at the firm. In the United States, the SEC has mandated the disclosure of CEO-to-worker pay ratios, although Canada has failed to adopt similar rules. The AFL-CIO, the largest consortium of labour unions in the United States, publicizes an **executive paywatch** program that maintains a **database of company pay-ratios**, as well as a **list of the highest-paid chief executives**. The UK-based **High Pay Centre** hosts a research team that is fully dedicated to the study of executive pay.

Excessive pay has increasingly become a concern among activist shareholders. There is an emerging norm towards 'Say on Pay' votes, which have been implemented across a **majority of the TSX Composite Index** and give company shareholders the opportunity to provide advisory votes on fair executive pay. Institutional Shareholder Services, the world's leading provider of corporate governance solutions, recommended that shareholders **vote against 10% of CEO pay packages** at S&P 500 companies during the 2018 fiscal year. Some investors have even requested that companies **justify their executive compensation** plans in light of broad-based lay-offs or employee pay cuts. For more information on executive compensation best practices, see the **indicators listed on pages 46-72 of this report** by Institutional Shareholder Services.

The Canadian Coalition for Good Governance has a model **Say on Pay policy**, which stipulates that boards should hold advisory votes on executive compensation reports contained in annual proxy circulars, and give shareholders an opportunity to provide their input on the structure of executive compensation plans. SHARE, a Canadian investor coalition, has developed a **framework for activist investors** looking to improve equity and fairness in compensation strategies. The UN PRI has authored a series of **broader guidelines for investors** aiming to reduce income inequality specifically through targeting high CEO-pay.

As You Sow, another major activist coalition, encourages shareholders to use their proxy power to target unjustified executive pay. Their **CEO pay initiative** aims to:

1. Engage shareholders and helping them hold money managers accountable for their votes;
2. Push companies to develop new social and environmental performance criteria, and work with them to do so;
3. Identify the most overpaid executives, the money managers that approved the compensation plans, the consultants that proposed them, and the compensation committee board directors that approved their compensation packages;
4. Encourage foundations and public funds to adopt stringent voting guidelines to address specific disconnects between pay and performance, as well as the systemic issues that drive the increases, such as peer group selection and inflationary ratcheting up of compensation.

The Net Positive World **Readiness Test** includes specific questions related to a company's use of share buybacks and dividends, which often benefit shareholders in the short-term at the expense of long-term value creation. It asks:

1. Is the firm spending more on stock buybacks and special dividends than investing in people, R&D, and long-term value creation?
2. Has executive pay at the firm risen faster than average pay over the past 5 years (i.e. have workers been left behind)?
3. Are there employees living at or below the poverty line?

For information about linking stakeholder relations and sustainability incentives to executive compensation packages, please see Section 4.2 on Leadership and Governance. For further information about wages, automation, and layoffs, see Section 2.4 on Labour Practices.

Case Studies

The regulatory context regarding executive pay levels is slowly changing, with new norms evolving around the world. As of 2019, UK firms are required to disclose and explain their CEO-to-average-worker pay ratios. Israel has gone further by instituting an upper limit on the compensation of executives in the financial sector, ensuring that no individual can make over 2.5 million shekels (CAD$905,000). Canada has yet to adopt any rules that restrict executive pay, make say on pay votes mandatory, or improve disclosure requirements.

There are a number of examples of investors using their voting power to take aim at excessive executive compensation. In the UK, 70% of shareholders **voted against the pay report** of the supermarket chain Morrisons, and 60% of Rio Tinto shareholders voted against the pay package of CEO Jean-Sébastien Jacques, who resigned after a scandal. The Norwegian sovereign wealth fund, the largest such institution in the world, has also made headlines for announcing its intention to **call for caps on executive pay** at the companies in which it invests, opening a window of opportunity for other large asset managers to make similar commitments.

Organizations/Initiatives

For further information about pay equity, income inequality, and corporate power, check out the following organizations:

- **High Pay Centre**
- **Fair Economy**
- **Oxfam**
- **DirectorWatch - Centre for Economic and Policy Research**
- **Hedge Clippers**
- **Economic Policy Institute**
- **Demos**
- **Institute for Policy Studies**
- **London School of Economics International Inequality Institute**
- **Columbia University Center for the Study of Wealth and Inequality**