Optimal CEO Compensation in Best National Interest

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Abstract

We propose a new paradigm to formulate optimal rules of governance to enhance unity, stability and competitiveness of a nation and to achieve as high individual prosperity as feasible. A maximum chief executive officer (CEO) compensation equal to a multiple (say, ten times) of the average employee salary is argued as optimal in the sense that it will immensely enhance national goals of unity, stability, prosperity and competitiveness.

A certain portion of the compensation of every employee including the CEO should include the company's common shares that can be sold only upon separation of an employee from the company. This is to protect the interest of shareholders.

We illustrate that under the current paradigm, the gross domestic product (GDP) and the CEO compensation can both grow dramatically, while the prosperity of an absolute majority falls precipitously.

Introduction

Alarmed by skyrocketing executive compensation relative to employee pays, the U.S. Congress has currently scheduled hearings from top CEOs and ex-CEOs in USA. The House Oversight and Government Reform Committee of the U.S. Congress notes:

In the 1980s, the CEOs of the nation's largest companies were paid 40 times more than the average employee. Now they make over 600 times more. At a typical company, 10% of corporate profits — a staggering sum — goes into the pockets of top executives.

These huge pay packages raise a basic question: Are corporate CEOs working for the companies who hire them or are the companies working for the CEOs?

Many academic experts, financial analysts, and investors believe that soaring CEO paychecks are a symptom of a corporate governance system that is not working. As noted, investor Warren Buffett has commented: "In judging whether Corporate America is serious about reforming itself, CEO pay remains the acid test."

Important questions that cannot be answered in such hearings from CEOs are:

- What should be the maximum CEO pay in the best national interest?
- How should the national interest be defined?

The current literature in the field of economics has no satisfactory answer to these questions. The current literature determines executive compensation to maximize the value of firms.[1] But even highly compensated CEOs may have committed excesses leading to failures of many mega firms like Drexel Burnhum Lambert, Enron, and MCI-World Com or driven other large firms like Merrill Lynch and Citigroup to the precipice of disaster. Whether the highly compensated executives strived for maximizing the market values of their firms is not important for the employees who lost their jobs due to executive excesses.

To the best of my knowledge, the extant literature offers no basis to address the optimality of skyrocketing executive compensation or mass employee retrenchments. Politicians across the divide have either tacitly supported such issues as normal or vehemently opposed them as excesses. Neither side has offered any reasonable optimal solution.

The field of economics may have rendered only disservice to the long run welfare of mankind. The crux of the problem may be the current paradigm of maximization of individuals' utilities of wealth. This paradigm has been used to derive "optimal" economic policies. But this paradigm may be inducing or brainwashing even the smart people to behave myopically and to undertake actions that are detrimental to humanity in long run. Economists employing this paradigm may justify the skyrocketing CEO compensation and employee retrenchment as rational.

A famous economist has said that every individual is dead in the long run and so what matters to him is the utility of his wealth during his life time. But rules of governance derived from such myopic economic paradigm or thinking can make even the talented individuals ineffective, i.e., unable or unwilling to produce globally competitive goods, services or ideas. Such paradigm has led humanity to (a) frequent wars by amassing mutually destructive weapons of mass extinction, (b) global warming, (c) depletion of ground water or pollution of surface water, (d) exhaustion of nonrenewable resources like oil and minerals, and even (e) inability of a nation to generate net exports.

Optimal Rules of Governance

We introduce here a notion of an ***optimal rule of governance*** for a nation to help make judgments about CEO compensation and to lay norms for such compensation as optimal for the nation. We define the optimal rules of governance as follows:

- Optimal rules of governance have to achieve national goals of unity, stability, universal prosperity and competitiveness. Prosperity is defined by net assets of households and competitiveness by net exports and foreign exchange reserves.

- Optimal rules of governance must be so comprehensively articulated that vested interests-including the political party establishments, religious gurus, academic professors, government establishments or anyone else-cannot reject such rules without publicly exposing themselves as opponents of national goals.

- Optimal rules for nations should lead to stability and prosperity of the global humanity.

Optimal rules so defined appear to be reasonable for a democratic nation. We believe that the above national goals will be accepted by all lawmakers and citizens of any democratic nation.[1]

We propose a <u>new</u> paradigm to formulate the optimal rules of governance to enhance unity, stability and competitiveness of a nation and achieve as high individual prosperity as feasible.[2]

We then turn to judging an optimal rule of governance on limiting the CEO pay as a multiple of the average employee salary of an organization. We argue how

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[1] ***Citizens for Development*** – a non-profit private organization at public service – researches and freely disseminates optimal rules of governance.

such a rule may help solve most problems facing a country like USA to make the nation stronger to lead humanity.

CEO Compensation in Best National Interest

How will the new paradigm of governance help set CEO wages? It is not optimal for a nation to raise the wages of only the CEOs. Neither is it optimal for a nation to remain indifferent to exponentially rising CEO pays, especially of faltering companies, when the employees' wages remain stagnant.

Left unbridled, a CEO who is brainwashed by the current paradigm of economics will continue to cannibalize or outsource jobs of his company to raise his wages incessantly to enhance his utility of wealth. This has been happening within USA and other democracies around the world. The current unbridled process is not in the best national interest and hence suboptimal because such CEO behavior can lead to social instability and disunity that are detrimental to national well being.

The new paradigm of governance behooves the lawmakers to specify norms for CEO salaries to enhance the national goal of unity and stability. Here is a norm based on this paradigm: the upper limit for a CEO's salary is no more than a multiple (say, ten times) of the average employee wage. Such a norm will induce the CEO to raise salaries of his employees. The President of USA has a salary that is close to this norm. A maximum CEO compensation equal to a multiple of the average employee salary will immensely enhance national goals of unity, stability, prosperity and competitiveness:

- The CEO will be motivated to enhance the average employee pay because only doing so will increase his own wages. An increase in average employee salary due to inflation or rising company profitability will translate into multifold increases in the compensation of the CEO.

- The CEO will still be induced to eliminate unproductive workers to enhance the long-term strength of his enterprise and to boost the average pay of his employees.

- He will be motivated by the necessity to keep his job long enough to earn pays till his normal retirement, leading to long-term viability and profitability of his company and strength of his employees.

- The CEO will desist from the current pervasive tendency to retire early after (i) usurping hefty unsustainable short-term bonuses and (ii) enhancing own pay raises based on cooked up short-term boost in company profits due to reckless elimination of vulnerable productive workers to rehire them as consultants for a fraction of pays and more hours of work.

- The CEO will have no incentive to outsource jobs because doing so will cut his own pay. He will outsource only if it leads to survival and competitiveness of his company.

- The debate about taxing the rich at higher rates will no longer be needed. A flat tax rate can be introduced to simplify the tax code and relieve the burden on the tax authority.

- Good incomes will accrue to the workers who are effective in producing globally competitive goods, services and ideas.

- The uselessness of current GDP growth will give way to truthful governance to enhance prosperity for all.

To protect the interest of shareholders of a company, a certain portion of the compensation of every employee including the CEO should include common shares to be vested only upon separation of an employee from the company.

An Example of GDP and CEO Compensation Growth Failing to Enhance Wages of an Absolute Majority

Suppose that a nation consists of one CEO making $200000 per year and his two employees earning $100000 each per year. The annual GDP is $400000 in this nation.

Suppose then that the CEO eliminates the more productive worker to rehire him as a consultant for $20000 per year. The CEO also borrows for the company $100000 from himself. This plan of cannibalization and increased funding will be supported by the less productive worker still employed, at least when this worker's pay rises by, say, $10000.

After restructuring, the CEO decides to take an increased salary of $300000 and the two employees get $20000 and $110000. Such restructuring raises the size of national economy (total income 300000+20000+110000) to $430000 from $400000 or a growth in GDP of 7.5%. The average employee salary falls to (110000+20000)/2 = $65000 or 35% and the CEO's pay rises 50% to $300000. The company's indebtedness grows by $100000. The company's cash position improves by $70000: cost saving of $80000 through firing and rehiring of a productive worker plus new debt $100000 minus increased pays of $110000.

This example shows that the gross domestic product (GDP) and the CEO compensation can grow dramatically in a nation, but the prosperity of the absolute majority can fall precipitously. The unbridled CEO sophistry to raise his pays drives the effective workers to perpetual economic slavery with long hours of work. Such sophistry is unfortunately camouflaged by raising GDP growth that the self-serving CEOs and ex-CEOs hoot as the strength of the U.S. economy. But the country is becoming vulnerable in reality.

Conclusion

A strong America that can enhance prosperity for all, achievable by the proposed CEO compensation rule, is obviously more desirable than a perpetually weakened, unstable, vulnerable and non-competitive nation characterized by economic bondage of the vast majority by a tiny fringe. Only a strong America can lead the world in making similar reforms.[2]

[1] Here is a paper by yours truly: ``Maximizing the Market Value of a Firm to Choose Dynamic Policies for Managerial Hiring, Compensation, Firing and Tenuring.'' *International Economic Review*, May 1992.

[2]Several missives to the U.S. presidential candidate Hillary Clinton may impelled her to assess, in the best interest of USA, the desirability of optimal rules of governance on CEO compensation and financial market reforms. See: "For Clinton, Government as Economic Prod," David Leonhardt, New York Times, January 21, 2008. http://www.nytimes.com/2008/01/21/us/politics/21clinton.html?pagewanted=2&hp

[2] A more detailed discourse on this is available in a paper, "Utility of Wealth, Policy and Governance,"
http://www.pro-prosperity.com/Research/UtilityWelfareDemocracy.pdf