Executive compensation: A prize in the corporate race

High executive compensation has received a lot of attention recently—primarily negative. But it serves an important purpose in attracting and motivating competent individuals.

By James B. Cloonan

Executive compensation is receiving considerable press coverage. It was, for instance, the cover story of the May 7 issue of "Business Week."

There is no doubt that many corporate stock owners will bristle at the list of hundreds of corporate executives being paid over $1 million a year. Most bristling will be done by—and should be done by—the stockholders of those corporations, whose executives are high on the compensation list but whose performance has been below average.

My opinion—with reservations that I will detail—is that high executive compensation is generally desirable. In fact, if I owned a significant percentage of U.S. corporations, I would push for even higher top executive compensation.

This opinion may sound strange. I generally support more corporate democracy. I am against anti-takeover maneuvers because they destroy the free-market protection against inept management. I don't like "golden parachutes" because they reward incompetence. Yet I support high executive compensation, and I do so from the viewpoint of a self-interested stockholder.

To give some perspective to the discussion, it is important to remember that we live in a society where the top 100 athletes and the top 100 entertainers probably make more than the top 100 corporate executives. The salaries of athletes, entertainers and executives may irritate many people because of the economic disparity. But there are, I feel, valid reasons for such income. Ultimately, these reasons benefit those connected with sports, entertainment and business.

There are two levels of justification for such incomes. The first, and the one more often discussed as justification, can be called "performance." The second, and the one I feel is the most important, can be called "motivation."

Justification for high salaries because of performance is argued on the basis of what individuals contribute in dollars relative to what they get. An entertainer that can provide millions of extra dollars to the box office can justify a large share of the extra receipts generated because of his or her talent. Athletes can argue for astounding salaries based on their production of runs, points, goals or on their ability to draw larger attendance. The board of directors of a large corporation can argue that the difference between an executive with ability "90" (on a scale of 100) and with ability "93" may be an additional $10 million in corporate profits and thus an extra $1 million in compensation is justified.

While there may be validity in these arguments, they are not what persuades me to support large salaries and bonuses. I am not too sure that the same number of people wouldn't spend the same amount on tickets if there was no Frank Sinatra or Martina Navratilova. I am also not too sure there is much difference in the abilities of the top 5000 executives in the U.S.

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What does convince me that high incomes are justified is what I call the motivation effect. How many young people would study music or acting if there wasn't that dream of the glory and money if they get to the top? How many young people would strive for ever-increasing proficiency in sports if there wasn't the dream that the rewards would be there if they really excelled? More importantly, would competent young people accept employment with large corporations without the knowledge that there is a significant reward if they win the competition with their peers? High executive salaries can be viewed, not as a payment for day-to-day services, but as a prize for having won the race—a prize that not only rewards the victor but motivates everyone else competing. After all, we don't condemn lottery winners, or at least those who buy lottery tickets don't. The winners' multimillion dollar victories only keep the rest of us buying more tickets.

I feel this need for motivation, whether the motives are money, status, power, or self-fullfillment, is extremely necessary in a complex industrial society such as ours.

Of all the ways available in the country to become a multimillionaire, the hardest by far is the executive ladder in a large corporation. For every 10,000 hopeful young management trainees, only one will get to the top and become truly rich. If you check the background of the multimillionaires in this country, very few achieved it by being executives of large corporations. Only the very top get the salaries and stock options that lead to real wealth. Most multimillioniares who didn't inherit their wealth got there by being security or commodity traders, or by having a profession that allowed expansion and accumulation. Many of the most capable young executives already perceive that there are better opportunities outside of large public corporations.

If we don't offer a prize to the winners in the corporate executive race, a prize comparable to the rewards of running a small business or being a successful surgeon or lawyer, then how do we get talented young people to run our industries?

In every state lottery, officials are discovering that giving fewer but larger prizes sells more tickets. As an owner of stock in America's large corporations, I feel that my long-term interests are served by encouraging more young people to join the corporate race. I might well support even higher compensation.

I do have some reservations about high executive compensation, however. These reservations hinge on the feeling that, if compensation is the prize for winning, then the race should be fair. While I support high compensation packages for executives who show they are winners by managing their corporations successfully, I certainly don't support high compensation for less than competent executives, or for those in losing corporations.

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Some judgement is needed when there are other factors involved. Asking labor to take a cut or cutting dividends and then increasing executive compensation just doesn't make sense. Most of this kind of problem relates to changes in compensation rather than the absolute level. Executives should have their compensation go up or down with corporate fortunes. The wise timing of increases and decreases may be more important for "good will" than the average level of compensation.

By and large, business decisions should be made on a business rather than an emotional basis. As a self-interested stockholder, I don't care if an executive makes a million dollars a year if there is a net gain to me either from performance or motivation.

I am willing to view executive compensation as a small advertising expense to attract and motivate good managers at lower levels.

James B. Cloonan is president of the American Association of Individual Investors. His column is his own opinion and is not the position of the Journal.