Chapter 11: What if We Outsourced CEO Jobs to Low-Wage Countries?

In 2004, Citigroup, Inc., one of the world's largest financial services companies, had a bit of a down year. The company lost its private banking license in Japan and had a large lawsuit settlement linked to its role in the WorldCom financial scandal. In a year in which median shareholder returns for financial services companies were 11.4 percent, Citigroup shareholders enjoyed returns of only 2.7 percent. Those low returns contributed to Citicorp's five year annualized returns falling well below the industry median, with just 6.5 percent compared to 10.8 percent.

So embarrassed by these results was Citicorp CEO Charles Prince that he requested a cut in his planned bonus, a cut which the board pay panel graciously granted, cutting the planned bonus by 15 percent. As a result, Mr. Prince's salary and bonus for 2004 as reported by The Wall Street Journal only turned out to be $17,133,300. This included a base salary of $983,300, and a bonus of $16,150,000. *

Stories like this are easy to find every year and are widely reported in the business press. Of course, there were lots of CEO's whose companies had very good years, and there were CEO's who saw their compensation decline from the previous year. But it's undeniably lucrative to be a CEO: according to The Wall Street Journal's Joann Lublin, citing the Mercer survey of 350 major U.S. corporations, the median salary and bonus increase for CEO's on the job two years or more was 14.5 percent in 2004, and total direct compensation (which includes the exercise of options given as long-term compensation) rose a stunning 40.9 percent to a median of just under $6 million. In the same year, median salary increases for non-union salaried staffers was 3.4 percent. Barely above the inflation rate, it was the smallest increase since the Mercer survey began in 1989. And the federal minimum wage stayed steady at $5.15 per hour, for the seventh consecutive year.

So, what's up with CEO compensation? Where can we sign up for jobs like these? It's a controversial subject that is endlessly debated in the business press year after year, with the only sure change from year-to-year seemingly being that this year's numbers will be more shocking than last year's.

As discussed in Chapter 11 of Modern Labor Economics, corporate America has been tying more and more of top executives' compensation to some measure of firm performance, in an effort to provide them with strong incentives to manage aggressively in the stockholder's best interest. While top executives at Fortune-500 companies may have annual base salaries that can exceed $1 million dollars, it is typical that their base salary will represent only a small percentage of total compensation in normal years, with few limits placed on how high that compensation can go if the company is very successful.

As Chapter 11 points out, designing an executive compensation system to achieve desired performance is a difficult task. If performance is judged based on annual profits, executives might become overly focused on the short run and not position the company properly for the long run. The same can be true if performance is evaluated on the basis of short-term fluctuations in stock market prices. In addition, profits (and subsequently, stock prices) are really the result of the efforts of thousands of workers. Perhaps even more importantly, profits are frequently the result of a strong economy or a "hot" sector, and may have little to do with executive decisions. The large bonuses so many executives received in 2004 followed a banner year in corporate profits. But if all of corporate America is doing so well, are the CEO's really doing anything special to deserve such large compensation packages, especially when their workforces are receiving relatively little in the way of raises? Despite the annual attention in the business press, and increasing opposition from shareholder groups such as large pension funds, few companies follow one of the most basic economic principles in designing CEO compensation plans. That principle would reward based on relative company performance. On that basis, Mr. Prince, whose company performed considerably worse than the average for his industry, would have been compensated accordingly. But as Ms. Lublin points out, few companies tie annual bonuses to comparisons with peer group performance.

Anecdotally, Ms. Lublin reports that a few companies seem to be trying to set the bar higher, looking at peer comparisons, setting higher triggers for options to kick in, and cutting back on lucrative severance packages.
It is the latter that is currently catching the attention of the French. As European CEO compensation has been catching up with that of their American counterparts, not everyone is pleased. The Wall Street Journal's Andres Cala reports that the French Finance Minister has promised to introduce legislation that will require shareholder approval for all CEO severance packages. The move is a reaction to a series of widely publicized payouts across Europe that have several countries considering regulatory responses. As in America, the greatest opposition to the awards arises when they are given despite poor company performance, though some suggest that populist opposition is also based in part on resistance to the European Union moving more in the direction of free markets.

*(With all due apologies to Mr. Prince, there were actually two different sets of numbers published for his bonus, and I'm going with the higher set. The lower number, from Ms. Lublin's article, suggested a bonus of $9.69 million, a nice increase over his 2003 bonus of $6.97 million. The higher number is reported in the WSJ/Mercer survey.)*

Sources:

a. Many companies have defended large executive compensation packages that don't appear to be justified with current company performance, as rewards for past performance. Do such rewards make sense?

b. Another justification often cited by companies for seemingly extravagant executive compensation packages is that competitive market pressures require them to pay well in order to attract and retain top managerial talent. Could paying less for less high-profile talent be a good bargain for these companies? Why or why not?

c. Pay-for-performance is much easier when performance is easily measured, such as counting the number of units of specified quality a factory worker produces, or the number of hits a baseball player gets. As suggested in the case, deciding how to measure performance for CEOs is more challenging. Describe what you think would be an appropriate set of measures for CEO performance, and briefly explain it in terms of how it would provide the appropriate incentives.