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Ideas for a More Prosperous Nation

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Executive pay should be determined by a company's shareholders and directors

Montreal, January 20, 2010 – A company's shareholders and directors are in the best position to decide on appropriate compensation formulas, and it would be unwise to impose greater regulation in an area that is a matter of internal corporate management. This is the main conclusion of an Economic Note released today by the Montreal Economic Institute (MEI). This publication was prepared by Michel Kelly-Gagnon, president and CEO of this independent research organization, and by vice president Jasmin Guénette.

Executive pay depends on performance

Without denying that errors may have been committed in evaluating appropriate amounts to be paid to executives, the authors emphasize that in most cases there is a close relationship between this compensation and a company's performance. For example, a review of the 1,088 largest U.S. companies revealed that, from 2005 to 2006, gains to executives from stock options rose 63% for companies that performed strongly but fell 38% for firms that performed poorly. In 2008, the median annual performance bonus paid to U.S. corporate executives declined by 19%, with sharper drops in industries that suffered the worst profit slumps. As well, economists have calculated that the six-fold increase in CEO pay from 1980 to 2003 can be explained entirely by the six-fold increase in the market capitalization of large U.S. companies.

"A company cannot attract good executives without paying the market price," Mr. Kelly-Gagnon stated. "The fact that 40% of American CEOs are now hired from outside the company – a proportion that has tripled in recent decades – provides evidence that this market is highly competitive."

The Economic Note provides a reminder that the economic crisis and the government rescue of bankrupt companies using public funds have served as a pretext for imposing pay caps on some executives. Co-author Jasmin Guénette observed that "when the government becomes a shareholder in a private company – far from an ideal situation given that electoral pressures and corporate management do not mix well – it can, of course, exercise its right to influence executive pay policies, just like any other company shareholder. However, apart from this unusual situation, the government has no reason to take a position on private sector compensation policies."

As regards the "say on pay" rule giving shareholders a direct say on a company's compensation policies, the authors say it is entirely legitimate for the shareholders, who are the owners of a company, to adopt this type of rule. However, they consider it preferable to leave companies free to decide so that the efficiency of different models can be compared rather than having say on pay imposed systematically by legislation.

The pitfalls of government intervention

The Economic Note also mentions examples of government intervention that have had unintended consequences on executive pay. For instance, in 1993, the U.S. Congress eliminated the tax deductions provided to companies for non-performance-based executive pay over $1 million, resulting in a shift toward variable compensation and, ultimately, higher overall executive pay. Strict disclosure requirements may also contribute to raising pay for executives by allowing them to compare their conditions more easily with those of their counterparts.

“Regardless of the populist comments we hear so often these days, corporate executive pay is a private matter that must be settled within each company,” Mr. Kelly-Gagnon added. “People with a concern for redistributing wealth should devote their energies to debating tax policies.”

The Economic Note published today, titled *Is there a problem with executive compensation?*, can be downloaded free of charge at www.iedm.org.

The Montreal Economic Institute is an independent, non-profit, non-partisan research and educational organization. Through studies and conferences, it informs public policy debates in Quebec and across Canada by suggesting wealth-generating reforms based on market mechanisms.

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