Executive Compensation and the Modern Industrial Revolution*

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October 1995

Abstract

The controversy over executive compensation reflects a populist attack on wealth and legitimate shareholder concerns regarding ineffective pay practices. These factors both reflect rapid worldwide political, economic and technological changes that have redistributed income (causing the populist revolt), and produced excess capacity (causing the failure of pay systems that reward size and growth rather than wealth creation). The new world economy has produced unparalleled opportunities to create wealth, even in sectors with few growth opportunities. In order to realize these opportunities, compensation committees must provide incentives to create, rather than destroy, value, and must not acquiesce to the populist attack on high pay.

*This article, based on a speech presented at the Workshop on Managerial Compensation, Strategy, and Firm Performance at Humboldt-University at Berlin, is largely excerpted from “Economics, Politics, and Executive Compensation,” forthcoming, University of Cincinnati Law Review.
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by

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I. Introduction

Few issues in the history of the modern corporation have generated the fury aroused by escalating chief executive officer (CEO) compensation in U.S. companies. Although the U.S. business press had followed CEO pay for decades, the CEO pay debate achieved international prominence in the early 1990s. The controversy heightened with the November 1991 introduction of Graef Crystal’s expose on CEO pay, *In Search of Excess*, and exploded following President George Bush’s ill-timed pilgrimage to Japan in January 1992, accompanied by an entourage of highly paid U.S. executives. What was meant to be a plea for Japanese trade concessions dissolved into accusations that U.S. competitiveness was hindered by its excessive executive compensation practices as attention focused on the “huge pay disparities between top executives in the two countries.”

Consistent with *Time* magazine’s labeling of CEO pay as the “populist issue that no politician can resist,” CEO pay became a major political issue in the U.S.. High CEO salaries emerged as a bipartisan campaign issue among the leading candidates in the 1992 presidential election. Legislation was introduced in the House of Representatives disallowing deductions for compensation exceeding 25 times the lowest-paid worker, and the “Corporate Pay Responsibility Act” was introduced in the Senate to give shareholders’ more rights to propose compensation-related policies. The Securities and Exchange Commission (SEC) preempted the pending Senate bill in February 1992 by requiring companies to include non-binding shareholder resolutions about CEO pay in company proxy statements, and announced sweeping the new rules affecting the disclosure of top executive compensation in the annual proxy statement in October 1992. In 1993, the Internal Revenue Service (IRS) defined non-

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performance-related compensation in excess of $1 million as “unreasonable” and therefore not deductible as an ordinary business expense for corporate income tax purposes, and the Financial Accounting Standards Board (FASB) proposed deducting the value of stock options upon grant from corporate earnings.

This article examines the political and economic forces that created the controversy over executive compensation in the U.S. and influenced the consequent reactions from Congress, the SEC, the IRS, and FASB. The political forces reflected the populist attack on wealth that followed the so-called “excesses of the 1980s,” associated with the perception that high CEO salaries were increasingly coupled with layoffs, plant closings, and an economic recession. High levels of CEO pay became a convenient rallying point for frustrated workers facing potential unemployment, and for labor unions facing inevitable declines in their economic and political influence. The economic forces contributing to the CEO pay controversy in general reflected that traditional executive pay practices established in the 1960s and 1970s were ill-suited for the 1980s and 1990s economies where creating shareholder value involves innovation and entrepreneurism in some sectors, and downsizing, layoffs, obtaining concessions from unions, and in extreme cases even exit in other sectors.

Underlying the article is the proposition that the political and economic forces behind the CEO pay controversy are two different sides of a common coin: both reflect fundamental and rapid changes in the U.S. and world economies that began in the mid-1970s and will continue throughout the next several decades. Traditional executive pay and human resource practices—designed for an economy characterized by continual growth in large corporations—fail to provide meaningful and appropriate incentives in this new economic environment. New, more effective, pay systems break traditional links between pay and size and between pay and accounting profits, and increase the link between pay and wealth creation.

II. The Modern Industrial Revolution and the CEO Pay Controversy

In his 1993 presidential address to the American Finance Association, Professor Michael Jensen characterizes ongoing worldwide economic, regulatory, and technological changes as the Modern Industrial Revolution. Jensen (1993) argues that rapid increases in technology, declines in regulation, growing worldwide capitalism, and globalization of trade have created massive excess capacity in many of the world’s industries, including automotive, retail trade, steel, tires, computers, and defense. Jensen traces the beginning of the revolution to the oil-price shocks in 1973, and argues that the revolution gained momentum during the 1980s and will fundamentally alter the world economy by the early twenty-first century.
Jensen documents striking similarities between the current revolution and the Industrial Revolution occurring a century earlier. Both revolutions were driven in large part by technological advancements that led to excess capacity and obsolescence in many sectors. The merger boom of the 1890s facilitated the transfer of resources from sectors with excess capacity to higher valued uses, similar to the merger and acquisition activity in the 1980s. Both revolutions produced dramatic increases in productivity and wealth, but also produced important redistributions of wealth that left many individuals worse off. As a consequence of the redistributions, both revolutions coincided with populist attacks on wealth and new policies that restricted the role of capital markets. In the 1890s, for example, public criticism of the so-called “Robber Barons” led to the Sherman Act and other U.S. antitrust policies; in the 1980s, public sediment against the so-called “raiders” and hostile takeovers led to pervasive state antitakeover legislation, poison pills, shark repellents, and the collapse of financing opportunities through the junk bond market.

Viewing recent changes in the world economy as a modern industrial revolution helps explain the connection between the political and economic forces behind the executive compensation controversy. The emerging market for corporate control, and the populist attack on wealth that ultimately shut down that market, are predictable responses to technological and economic changes that created excess capacity, obsolescence, and wealth redistribution. Given that investors can no longer rely on control transactions to discipline managers, it is also predictable that investors turn toward corporate governance—including the selection and compensation of executives—as a key remaining mechanism to discipline underperforming managers. Unfortunately, as Jensen documents, corporate governance systems have been largely unsuccessful in facilitating the timely downsizing and exit needed to reduce excess capacity. The failure of corporate governance systems—as evidenced by the overdue changes at IBM, General Motors, Kodak, Westinghouse, Sears, and scores of other companies—have exacerbated the economic pressures to reform CEO pay in ways that provide incentives for managers to take actions that create value in the new world economy.

Recognizing the populist attack on wealth as a response to inevitable wealth redistributions adds perspective to the political forces underlying the pay controversy. Workers in obsolete sectors suffer from technological growth, while those earning union wage premiums suffer from increases in (non-unionized) domestic and global competition. Even workers who remain employed in established industries experience real losses in their human capital and future promotion prospects. It is both predictable and understandable that the collective frustration of these workers will be vented as an attack on highly paid CEOs and others perceived to be benefiting from the economic turmoil. But, what is often lost in the public debate is that the redistribution reflects not merely wealth transfers but rather wealth
creation generated by the transfer of resources from lower- to higher-valued uses. For example, although critics decried the 1980s as a decade of greed and excess, the control transactions during the decade created economic wealth in the U.S. exceeding $1 trillion and facilitated dramatic increases in productivity, welfare, and economic efficiency (Jensen 1991, 1993). Compensation committees must therefore be careful to distinguish between populist attacks on high pay and legitimate shareholder concerns regarding pay practices that provide incentives to destroy, rather than create, value.

III. CEO Incentives, Value Creation, and Downsizing

The existence of excess capacity in an industry implies that increased investment in the industry earns less than the cost of capital and therefore destroys value for shareholders and for society. However, excess capacity offers important opportunities to create value even in the absence of profitable investment opportunities. In particular, creating value under excess capacity involves diverting resources from activities that earn less than the cost of capital, which in turn implies transferring human as well as physical capital from industries with excess capacity to alternative sectors. Stock repurchases, dividends, special distributions, and cash acquisitions within an industry create value under excess capacity by paying out cash to shareholders rather than spending it unproductively (Jensen 1986). Similarly, workforce reductions through layoffs and attrition create value by facilitating the transfer of workers to sectors where their skills and effort are more highly valued by society. The transfer of human resources, unfortunately, often imposes real costs on redeployed workers—especially in the short run—but is nonetheless an efficient and necessary response to excess capacity.

A. Why Traditional Pay Practices Discourage Downsizing

Traditional top-management pay practices provide strong incentives to invest and grow, and provide strong disincentives to downsize in response to excess capacity. These traditional pay practices may have been effective in the growth economies of the 1960s and early 1970s where the actions that created size and growth were closely correlated with the actions that created value (Baker 1990). These same practices, however, provide incentives for continued growth not warranted by the market, and thus have contributed to excess capacity in many industries.

As I’ve argued in a recent article on the U.S. defense industry (Dial and Murphy 1995), there are several reasons why managers paid under traditional systems are unlikely to adopt
downsizing strategies even when these strategies produce the highest benefits for shareholders and society.

Managerial compensation is typically tied to firm size and/or span of control (Healy 1985). As is widely documented in both academic research and practice, company size is the most important determinant of the level of executive compensation. The link between pay and size is not surprising, since larger firms in general require (and must pay for) managers with increased skills and abilities. The pay-size relation has been institutionalized, however, by widely utilized compensation surveys that use size as the primary, if not the only, determinant of pay levels. Since, under traditional pay practices, compensation levels are set based on comparisons with pay in similar-sized firms, managers who downsize are taking actions that will ultimately result in lower levels of pay.

Annual bonuses are typically tied to accounting profitability. Downsizing often involves large restructuring charges that reduce accounting profits in the short run. Encouraging voluntary attrition through early retirement, severance programs, and retraining programs also increases current expenses, thereby decreasing current accounting profits. In addition, gains associated with sales of plants or divisions are often not included in net income. Thus, managers pursuing downsizing strategies will realize immediate reductions in their annual accounting-based bonuses.

Non-monetary compensation is also indirectly linked to firm size and growth. The value an executive receives from his position includes his monetary compensation and also includes important non-monetary elements such as power, prestige, and community standing. These non-monetary aspects tend to be linked to firm size and survivability and not to shareholder wealth creation. Managers closing plants and presiding over workforce reductions often become unpopular figures in their communities. The financial rewards for downsizing must be sufficient to offset these potentially important reductions in non-monetary compensation.

Laying off employees and leaving communities is personally painful for managers. It is relatively easy to provide incentives for growth: managers intrinsically enjoy opening new plants, hiring new workers, and announcing new investment programs. In contrast, few managers enjoy downsizing: it's simply less fun than growing. In addition, affected employees and communities impose large non-pecuniary costs on managers, which further reduces the managers incentives to downsize.

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5 Dechow, Huson, and Sloan (1994) present some evidence that compensation committees often implicitly adjust accounting-based bonuses for the negative consequences of restructuring charges.

6 See, for example, “The Pain of Downsizing,” Business Week (May 9, 1994).
Managers often embrace survival and not value creation as the ultimate objective of the organization. Many managers don’t understand and too easily dismiss exit as an appropriate long-run strategy for an organization, even when this strategy creates the most value for shareholders and society. Managers focused on corporate survival will resist exit and pursue costly and inefficient diversification into product lines where they have no expertise or competitive advantages.

Downsizing may ultimately cost the managers their own jobs. CEOs with successful careers in multiple industries are rare, since managers often possess expertise that is specific to a particular industry and not readily transferable across industries. Declining industries inevitably end up with fewer firms—and therefore fewer managers—that before the industry contraction. Managers creating value by initiating or speeding the inevitable downsizing process may therefore be managing themselves out of a job.

B. Effective Compensation in the New World Economy

The strong pressures on managers to avoid downsizing strategies suggest both the difficulty and importance of designing effective compensation and incentive systems for managing in the current world economy. To reduce the pressures described above, effective compensation systems break traditional links between pay and size and between pay and accounting profits. Success must be defined in terms of wealth creation rather than in terms of size, survival or stability, and the rewards for creating wealth must be sufficient that managers are willing to sacrifice their own positions, if necessary. Rewards should also be structured to reduce the potential political fallout from high potential payouts.

In practice, effective pay-for-performance contracts combine below-market base salaries with high potential payoffs based on stock-price appreciation (including dividends). Annual and long-term bonuses plans based on accounting profits rather than stock-price performance are reduced or eliminated, and are replaced by increased grants of stock options and restricted stock. Although not a perfect measure of wealth creation, stock prices reflect the market’s estimate of the company’s current and future cash flows, which in turn reflects the market’s beliefs regarding the company’s investment (or disinvestment) opportunities and how managers will respond to those opportunities. The empirical evidence of positive stock-price reactions to restructurings, downsizing, repurchases, and shareholder distributions in declining industries support the hypothesis that these industries offer few growth opportunities but substantial opportunities for creating wealth.

Implementing effective compensation structures is difficult because managers will resist cuts in their salaries and elimination of their annual bonuses. Managers will also resist tying an
increasing portion of their compensation to shareholder returns, arguing that stock prices are
driven by the “vagaries of the market” and by too many factors outside of their control. I
believe that this predictable resistance reflects two primary factors. First, stock-based
compensation is riskier than salaries, and risk-averse managers are therefore unwilling to
accept a dollar-for-dollar exchange of salaries for restricted stock or options. Part—but not
all—of the riskiness of stock-based compensation can be eliminated by measuring performance
relative to the performance of the market or a relevant industry peer group (Gibbons and
Murphy 1990). Ultimately, however, the exchange cannot be on a dollar-for-dollar basis:
companies must give an executive more than a dollar’s worth of stock or options in order to
extract a dollar cut in salary. Fortunately, and importantly, incentive compensation is not a
zero-sum game: exchanges can be structured that simultaneously make executives and
shareholders better off.

The second factor that explains managements’ resistance to high stock-based
compensation reflects decades of managers’ excessive focus on earnings-per-share, and a
general lack of understanding of how their actions create or destroy value for shareholders. A
CEO striving to reach a 10% return on assets, for example, understands the changes in
revenues and costs of goods sold required to meet this objective, and can introduce the
appropriate divisional budgets and intermediate performance goals. The same CEO, astute at
reaching the ROA objective, might have no idea how to increase his company’s stock price by
10%. Many CEOs, for example, don’t understand that diverting resources from negative net
present value projects creates value as real and tangible as spending resources on profitable
projects. Stock-based compensation provides strong incentives for managers to learn about
how their actions increase or destroy value, although some companies may need to replace the
EPS-focused incumbent manager with one with a value-creation mentality.

The cumulative effect of the changes proposed above is a fundamental shift in the
corporate and management culture towards a shareholder-driven organization better equipped to
succeed in the new world economy. Although the compensation restructuring was motivated
in terms of providing incentives to downsize, in actuality it provides generic incentives to create
wealth regardless of the company’s economic situation. In high-growth companies, the
proposed structure provides incentives to invest and grow, in stable companies it provides
incentives to cut costs and manage for cash, in declining companies it provides incentives to
downsize and return money to shareholders who can invest it more productively.

It is important to provide generic incentives for creating wealth, rather than providing
specific incentives to divest and shrink in some situations, and to invest and grow in others.
While the Modern Industrial Revolution has created excess capacity in some sectors, it has also
created enormous growth opportunities in others. Illustrating the economic schizophrenia, Business Week issued a cover story on “The Pain of Downsizing” (May 9, 1994)—documenting the difficult downsizing efforts occurring in scores of U.S. companies—followed the next week with a cover story on “Why Are We So Afraid of Growth?” (May 16) focusing on the rapid changes in technology, innovation, and productivity that have created unparalleled growth opportunities in scores of U.S. companies. Although Business Week missed the irony and significance of pairing the successive cover stories, they are intrinsically linked as ramifications of the Modern Industrial Revolution.

Providing generic incentives to create wealth implicitly shifts the burden of strategy formulation from the board of directors to the top management team. This shift is appropriate, since board members do not have the time, expertise, or information required to design the organization’s strategic and operating objectives. Moreover, compensation policies that are tied too closely to a particular strategy provide few incentives to revise the strategy when the economy changes. In contrast, the proposed compensation structure provides incentives for managers to monitor and question their adopted strategy continually, revising or overhauling when necessary.

VI. Conclusion

Compensation committees face the daunting task of reshaping executive compensation practices to adopt to the new world economy. Rapid changes in technological growth, coupled with deregulation, global competition, and the rise in worldwide capitalism have created substantial excess capacity in some sectors, and dramatic growth opportunities in others. The changing economic forces have produced countless opportunities to create wealth. Companies that cling to traditional pay practices, or that yield to political pressures by restricting rewards for superior performance, will be unable to exploit these new opportunities and will continue to destroy wealth in the process. Companies that provide meaningful incentives tied to wealth creation—coupled with managers who understand how their actions create or destroy value—will ultimately capture a disproportionate share of the emerging wealth opportunities.
References


