Executive Compensation and other Parasitic Loads

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Executives of large corporations are usually paid far too much and paid way too soon which compensates them for results they don't produce and encourages them to make decisions which produce immediate profits but put their organizations at strategic risk. The relationships between these executives and their corporations are parasitic rather than symbiotic and the tragic consequences obvious in the collapses of AIG and General Motors. Executives expect excessive pay for the same reasons that male dogs lick their genitals: they can do it, all their peers do it, they are comforted by it, and occasionally they are stimulated to take action.

In the real world it normally takes at least 3 years for the consequences of executive level actions to become measurable with any degree of confidence; the larger the corporation, the longer the delay. If the incentives and bonuses paid to executives were rational or mutually beneficial, they would correspond to strategic results as they became measurable.

A CEO's job includes: hiring and managing other top executives, establishing and implementing corporate policies including establishing the level of R&D expenses, investing in modernization, resolving intrinsic resource allocation conflicts between departments and divisions, selecting products and markets, making the final decisions on mergers and acquisitions, and dealing with key stakeholders outside the organization such as the Board of Directors, banks, investors, and key customers. Finding, recruiting, hiring and bringing other executives up to speed takes at least 1 to 2 years and their contributions aren't reliably measurable for some years after that. Mergers or acquisitions and new product lines likewise take years to prove as wise or foolish. So it seems strange that top executives are incentivized in the current year for this year's performance, as measured by profits or stock valuation. At best, CEOs and other executives, should be measured and receive such compensation several years down the road; whether or not they remain in the employ of the corporation.

I suspect that excessive pay is a cultural phenomenon rather than a conspiratorial one; a business culture that took decades to degenerate to its present level of insanity. It probably started with the inherently incestuous relationships between CEOs and their Boards of Directors. Boards select CEOs and thereafter CEOs normally approve new board members; tending to approve individuals who are favorably biased towards them rather than ones who would critically evaluate their performances. Boards in turn determine CEOs' compensation packages. The path of least resistance for a Board is to perpetually increase a CEO's compensation to keep him/her happy (with the Board) and to retain the CEO's services. Eventually this began to produce compensation packages which favored the CEO's at the expense of the other stakeholders, at first in amounts that were small, diffuse and difficult to measure. However, once a few companies began to pay their executives too much and too soon, other Boards began to follow suit for "competitive reasons" and a compensation race ensued and excessive pay for short-term results became the norm.

Overpaid CEOs usually overpay their subordinates to encourage personal loyalty, to reduce the number tough personnel decisions they might otherwise face and to reinforce the "rightness" of the CEO's own compensation. Although these costs hurt bottom lines, growing companies can usually afford them, everyone is doing it and it keeps people happy. Growth and economic prosperity mask the parasitic effects of executive genital licking.

Incentive compensation for executives has thus degenerated from symbiotic to parasitic. A symbiotic relationship is an interdependence in which two or more parties provide vital services to one another to the mutual benefit of all concerned. A parasite, (tapeworm, pinworm, hookworm, tick, leech, head lice, flea, etc.) takes nourishment from its host but provides little or nothing in return and may even introduce a pathogen or two.

Grossly overpaid executives are parasites to their corporate hosts. Parasites, individually and collectively don't usually kill their hosts but systematically weaken them, making them more vulnerable. Corporations, like animals or humans, tend to accumulate parasitic loads over their lifetimes. Nature reduces the average parasitic load on each species by building in term-limits for its individuals. The species "corporation" initially had such term limits: when first established, corporate and bank charters were limited to 21 years, subject to deliberate renewal by governments. With the help of corporate lobbying, these term limits were removed.

Excessive executive compensation is only one kind of parasitic load. Other kinds include contractual agreements that commit the company to pay future benefits without fully funding those commitments from the work of those who receive them; i.e. defined benefit agreements instead of defined contribution agreements. They also include outmoded policies, procedures and corporate operating myths.

For example, the accumulation of excessive salaries, bonuses, underfunded benefits and unprofitable dealer contracts have so weakened GM, Ford and Chrysler that they have become uncompetitive in the struggle to compete with younger auto manufacturers who don't have comparable parasitic loads. Some of the parasitic agreements which brought these companies to their knees were entered into decades ago by executive who found it easier to make parasitic commitments than to negotiate "pay for measurable results" agreements. Such agreements dug holes in the futures of these corporations, while the executives who dug the holes were applauded, and received their personal salaries, stock options and bonuses based on current results. By the time the negative consequences became obvious, the perpetrators were long gone and safe from accountability.

By 2007, GM, a dominant competitor in earlier decades, had accumulated benefit liabilities for retired workers of well over $1500 per vehicle. This put them at a distinct competitive disadvantage to newer companies without this parasitic load. They postponed the consequences of this weakness by marketing large gas-guzzlers with high profit margins and by lobbying the Federal Government to avoid clean air regulations to keep their companies limping along. In 2008 they were bankrupt.

Major employment agreements are other kinds of CEO choices whose overall benefits or liabilities to the Corporations are not obvious for several years, perhaps even for decades. Yet the CEOs and other executives who make these decisions receive, at best, compensation based on the immediate impacts of those agreements and on the results of their predecessors' actions. Out of whack executive compensation has thus systematically encouraged short-term decisions and short-term thinking.

I suggest that society would benefit by reinstituting 60-80 year term limits on corporations; by which time any corporation would have had to systematically dissolve itself, satisfy its contractual obligations, dispose of its assets and pay off its investors. This is a serious suggestion, the result of deep consideration of all the trade-offs that such a legal change would produce. The initial reactions to this suggestion will most likely be intensely negative, and fatal flaws will seem overwhelmingly obvious. I encourage you to think about the idea and its ramifications; the strategic and pro-active benefits are worth considering and may well be essential to the health of our industrial and financial systems. I will write more about this proposal in my blog at www.dismountingourtiger.com where I will also document a broader basis for it and more details on how to implement it.

It's remarkable that the consequences of parasitic relationships are not worse than they are. Some CEOs, a very few to be sure, have tried to make wise long-term decisions in spite of the fact that these decisions will reduce their compensation. For example, launching a new product line may be unprofitable for several years. It takes courage to maintain a high level of R&D and to introduce new products, particularly those which cannibalize existing product lines, when the alternative of reducing R&D expenses or delaying new products improves this year's bottom line and jacks up personal compensation.

When it comes to excessive compensation, the parasites who receive it are cheered on by other parasites who live off their waste. Rudolph Giuliani, formerly mayor of New York City, recently defended the excessive bonuses given members of Wall Street firms on the basis that the city budget benefitted from the freewheeling expenses of highly paid executives.

It should be clear, in hindsight, that the recent financial crisis was fostered by out of whack compensation up and down the line in banks, brokerage houses, home mortgage companies, hedge-funds, etc. The people who committed these organizations to strategic risks, such as mortgage backed securities or credit default swaps which brought tactical "profits" and longer term disasters, collected their ill-gotten compensation before the shit hit the fan and left it for others—less lavishly compensated— to pick up the pieces.

Speculative thought: An unintended consequence of lowering taxes at the high end has been to greatly increase the financial parasitic load on corporations. Until the 1970s, executive salaries were subject to income taxes up to 91% for incomes over $200k, levels set up prior to WWII and maintained through the 1960's. Strangely, in spite of current mythology about ever lower taxes favoring business, the 1950's and 60s were arguably one of the strongest and healthiest growth periods in US history. The ratios of Executive salaries to average wages were relatively low during those years, in part because it was so inefficient (from a corporate point of view) to increase them, and executive status was affirmed by untaxed perks.

Golden Parachutes

Golden parachutes are another form of parasitic compensation. They are usually rationalized by Boards of Directors and by the executives who receive them on the basis that outstanding CEO's would not accept employment without such parachutes because they can get them elsewhere. Furthermore, top executives claim that are vulnerable to arbitrary dismissal by the Board of Directors, so they need guaranteed compensation. From my experience as a CEO and a board member, a golden parachute is neither desirable nor necessary. It, along with excessive compensation, inhibits a Board from terminating non-performing executives, when the buddy system and personal reluctance by board members to admit that they made a poor choice, already provide substantial barriers to taking such actions. Executives should serve at will; if they can't accept the personal risks, they shouldn't be running things.

Executives who need Golden Parachutes are no longer top executives but risk-avoider has-beens with reputations. Executives who believe in themselves and are worth their salt will assume personal risks in return for opportunities to implement their strategic visions. I wouldn't hire any executive who needed a Golden Parachute, just as I wouldn't hire other applicants whose primary criteria included extended vacations and retirement benefits.