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IT'S NOT THAT WE PAY CEOs TOO MUCH. IT'S THAT WE PAY EVERYONE ELSE TOO LITTLE.

the pay PROBLEM

By Don Delves

THE OPENING SENTENCE OF MY FIRST BOOK, PUBLISHED IN 2003, WAS, "EXECUTIVE COMPENSATION IS OUT OF CONTROL." PLENTY OF CORPORATE CRITICS AGREED, BUT I KNOW FOR A FACT THAT I WAS THE ONLY EXECUTIVE-COMPENSATION CONSULTANT TO SAY IT IN PRINT. THE BOOK WENT ON TO ARGUE IN FAVOR OF AN EXPENSE FOR STOCK OPTIONS, WHICH AT THE TIME WERE BASICALLY VIEWED AS HAVING NO COST AND WERE BEING HANDED OUT TO EXECUTIVES AND OTHER EMPLOYEES AS IF THEY WERE FREE.

I risked my career and livelihood to say those things because I thought they needed to be said and hoped they would lead to better governance of executive pay. My hopes have at least partially come true, albeit with some unintended consequences. Executive compensation *was* out of control, but contrary to popular belief, it is no longer so. It is just high—and there is a difference.

CEO pay rose dramatically in the mid-to-late 1980s, shocking the public with "mega-grants" of stock and options, along with the introduction of golden parachutes and tax gross-ups. Then, in the '90s, CEO pay exploded, increasing by an astounding 400 to 600 percent in just a few years. Most of that explosion in pay was in the form of stock options. At the beginning of the decade, we were shocked when an

THE BOTTOM 80 PERCENT OF THE U.S. POPULATION HAS BASICALLY NOT PARTICIPATED IN THE GROWTH OF THE ECONOMY FOR A VERY LONG TIME. THEIR STANDARD OF LIVING MAY HAVE INCREASED DUE TO TECHNOLOGY AND DUAL-INCOME HOUSEHOLDS, BUT THEIR WAGES HAVE NOT.

occasional CEO received a one-time mega-grant of options valued at three times his salary; by the end of the '90s, that was the size of the typical median *annual* option grant to a CEO. At the beginning of the '90s, the total cumulative number of stock options granted to employees at most companies were about 5 percent of outstanding stock; ten years later, that number had increased to 15 percent—and was much higher at technology companies.

This means that the boards of directors of almost all publicly traded corporations gave away to employees—mostly executives—about 10 percent of the future growth in their company's value. (Since an option is the right to buy a share of stock at today's price anytime over the next ten years, it is the right to a share in the growth in the value of the company. Any growth in value given to employees is unavailable to other shareholders.)

Fortunately, the explosion abruptly fizzled in 2001 with the bursting of the dotcom bubble. CEO and executive compensation generally peaked that year, came down a bit, and settled in a range that has been fairly steady (adjusted for inflation) ever since. There was no undoing of the explosion of the '90s, but pay has generally leveled off.

So how high is it? Annual pay for a Fortune 500 CEO runs between $9 million and $12 million. (Heads of smaller companies are paid much less.) It moves up and down with company performance much more than it used to. It is composed of a salary of around $1 million to $1.5 million, an annual incentive of $1 million to $4 million, and the rest in various forms of stock compensation, including stock options. The annual incentive and some of the stock compensation rises and falls with company financial performance. The value of the stock compensation rises and falls, sometimes dramatically, with the company's stock performance. So most of the pay package is tied to company performance one way or another. None of these CEOs risks destitution for poor performance, but substantial swings in take-home pay are both possible and common.

This does not mean that there are not egregious exceptions where CEOs and other executives are paid handsomely for failure. And many of the big financial firms engaged in highly questionable pay and incentive practices that fueled the financial crisis and recession. But CEO and executive pay in general does track company performance reasonably well, and to a much greater extent than it did ten or twenty years ago.

Beyond this, corporate governance has also improved dramatically in the last decade, largely due to the Sarbanes-Oxley Act, passed in 2002, in the wake of the Enron and WorldCom disasters. After a decade of largely independent recruiting decisions, boards are far more independent and are no longer handpicked by the CEO. Under increased shareholder scrutiny and SarbOx rules, key committees are now composed entirely of outside, independent, non-executive directors. The image of a corporate board as a group of the CEO's cronies who just want to make him happy and do his bidding is an anachronism.

HOW MUCH INEQUALITY IS TOO MUCH?

This is an enormous amount of very positive change in just ten years, which leads to a key question: *If CEO pay is actually tied to performance, and corporate governance has improved so much, why are people still so angry?*

This question came to a head for me in an interview with a smart journalist in the summer of 2011. I was explaining how executive pay had fallen significantly during the recession and then rebounded—in a very appropriate way—as corporate profits improved. She paused and asked, "Well, Don, that is great, but what do you say to the typical factory worker in Peoria, Illinois, whose pay has not increased meaningfully in the last ten years?" I had no answer. The disparity bothered me then, and it still bothers me today. It is the crux of a significant societal problem, and may be at the core of what ails our economy.

The problem, as I see it, is not just that CEOs are paid so much. It is that most people are paid so little. In real terms, the typical American worker's pay has increased either very little or not at all over the past thirty to forty years, depending on which study you read. The bottom 80 percent of the U.S. population has basically not participated in the growth of the economy for a very long time. Their standard of living may have increased due to technology and dual-income households, but their wages have not.

Economists and pundits have written a great deal about growing inequality in America—how the top 0.1 percent or 1 percent or 10 percent has reaped an increasingly and startlingly large share of the increase in income and wealth over the last few decades. The data is incontrovertible. The question is not whether this has happened but, rather, what are the consequences?

Granted, I have never been particularly swayed by concerns

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over inequality, since capitalism requires a certain amount to function. However, too much inequality poses a real problem for a capitalist economy: If the majority of workers cannot expect to make any more money, to contribute meaningfully to the performance of their company and share in the rewards, then why would they strive to work harder, smarter, or more productively?

My fear is that we have lost the hearts and minds of much of America's workforce. The core engine of our economy is unengaged or, at least, underengaged. The workforce that was once the world's best is no longer. If this is true, it explains at least part of our persistent economic challenges. It also raises serious questions about most people's ability to save, to invest, and to retire—but those are topics for another article.

GAINS NO LONGER SHARED

I have been a compensation consultant since the mid-1980s. Back then, and in the early '90s, we spent a substantial amount of time working with clients on various types of gainsharing plans. They had many names, but all had the same objective: to give employees greater influence over business results and share part of the financial rewards with them. This was usually done in factory and manufacturing settings. Employees were organized in such a way that they could make improvements, adapt to changing conditions, and work smarter to increase the productivity of their plant or assembly line. They were educated in how the plant operated and made money, they were given access to information on the plant's performance, and they were given a share in the resulting performance improvements—usually in the form of a monthly or quarterly addition to their paycheck. The share was typically permanent, as long as the gain in productivity lasted. Employees could build their pay as they improved performance. It was a win-win for the company and the employee.

Twenty or twenty-five years later, the idea sounds a little utopian. But it really happened, and it really worked. No doubt many plants and other operations still use these plans, but they have become relics of a bygone era. That is really too bad.

What happened to gainsharing plans and the whole movement to empower workers, get the best from them, and share the rewards? Four reasons:

The rise of China, India, Mexico, and other countries as less expensive places to manufacture. The impetus behind gainsharing was increased productivity, but it required a lot of effort to make it work. In many ways, it was easier to move manufacturing to lower-cost environments than it was to get more production from existing American workers.

The dramatic increase in factory automation. Robots and such were uncommon in the late 1980s but are everywhere today.

Stock options. The 1990s saw an explosion in the use of stock options; many, many companies granted them to all employees. They were seen as a win-win benefit that would make all workers think and act like owners, and the strategy worked to some degree as long as the stock market was booming. It does not work so well in a flat market, since, obviously, options have no value to workers unless the stock price rises. (Some technology companies—most prominently, Microsoft—moved away from stock options and now grant whole shares of stock to most employees, but this has been done only by firms with a high percentage of high-tech knowledge workers.) It is also now prohibitively expensive to grant options or stock to all employees—the unintended and disheartening consequence of the expense for stock options. What once was free now carries a significant accounting cost. Almost all companies that once granted options (or stock) to all employees now grant them only to middle management and above.

The growth of the service economy. As the manufacturing economy has shrunk, employment in the service economy has grown: A significant proportion of American workers are now employed in industries such as hotels, retail stores and distribution centers (e.g., Amazon and other online retailers), and restaurants. These now comprise many or even most of the economy's lowest-paid workers. And their employers have barely begun to tap their collective knowledge, creativity, and ingenuity—nor share profits with them in meaningful ways.

Another factor that may be playing a role in the stagnation of worker compensation is education. The United States has strongly emphasized the importance of a college degree and worked to provide access to anyone seeking one. This goal is admirable and ambitious, but how many more C+ liberal-arts grads from third- or fourth-tier schools can the economy accommodate? The answer is probably zero.

What we do need, desperately, are people with solid technology educations who can fix our endless supply of broken gadgets, update the robots in our factories, and repair our crumbling infrastructure. Other developed countries—Germany in particular—have world-class technology tracks for students who choose not to follow the baccalaureate track, and they can make a very good living in high-value-added manufacturing jobs.

ALIGNMENT AND ENGAGEMENT

What can we do about this critical societal and economic problem? Others have advocated various tax and government policy remedies. But this is first and foremost a business problem; it is and has always been the role of businesses to provide opportunities for employees to make a valuable contribution, and to reward them for that contribution. It is increasingly the job of businesses to provide *meaningful* work and the opportunity to learn, grow, develop, and positively influence the business.

Current research in the field of self-determination theory suggests that people need three things to thrive in a work environment: *competence*—a sense of mastery, of being good at something, of being able to make a valuable contribution; *autonomy*—a sense of control or influence over one's environment and one's future; and *relatedness*—an ability to relate to and work with others in a meaningful and satisfying way.

There is also a body of research that shows that monetary incentives can have perverse consequences, especially when the task requires creativity or innovation. So this is clearly not just a matter of pay. Nor was that the case with the gainsharing programs of twenty years ago. Then as now, several things are required to effectively and productively engage employees:

* A work structure that allows or promotes employee contributions, ideas, innovations, and improvements;
* Education on how the business works, how it makes money, and how employees can contribute;
* Measurement of performance and productivity in real time, or as close as possible to real time; and
* A compensation model that shares performance improvements with employees and is transparent and fair to employee and employer.

Most research shows that it also helps if the employee feels that the mission and values of the company are something he or she can align with and support. If people go to work

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every day feeling that their values are at odds with those of their employer, or do not believe in the company's mission, then they may do the job, but their heart will not be in it, and they will view their pay as "compensating" them for doing something they really don't believe in. Conversely, if employees feel that their values are aligned with those of the company—or they can choose to align with the values of the company—they are much more motivated and engaged in their work. Think of companies such as Southwest Airlines, whose employees go to work every day knowing that their mission is to make it cheap, easy, safe, and reliable for grandmothers to visit their grandchildren, for parents to see their kids' graduations, etc. Or Whole Foods Market, which has a purpose, mission, and ethic that are compelling, real, and operationalized. (Store employees have autonomy in selecting new employees, selecting and buying products, and relating to customers; performance is measured not just at the store level but at the department-within-store level, and employees participate in the profitability of their department and of the store.) Or the yoga-clothing chain Lululemon, which has a mission-oriented business model and expects its employees to have detailed personal and professional growth plans that are shared with other employees.

One restaurant chain—I can't name it here—is developing a program to educate its servers, cooks, bartenders, and managers on how the business operates and makes money, and empowering them to do a variety of things that increase the profitability of the restaurant. A single restaurant is a definable business unit that can be run in a more entrepreneurial way, such that all or most employees can be involved in things such as bringing in more customers, improving customer loyalty and return visits, improving food quality and accuracy of orders, enhancing the guest experience, increasing the average tab, and increasing tips. The resulting difference in store performance is more than enough to share meaningfully with employees and still benefit the company and shareholders. It will also allow some employees to earn benefits and make enough to support a family instead of just providing supplemental income. Employee turnover is much lower than the industry average, and longer-term employees make more money for the restaurant. It is a truly virtuous cycle.

Programs such as these are difficult to implement and maintain. Best Buy offers a cautionary tale. A few years ago, Best Buy experimented with a brilliant and exciting approach to empowering and engaging employees in a selected group of "lab stores." All employees in a given store were taught how to form and test a hypothesis about how to improve store performance. They had to survey at least five hundred customers to prove their idea had merit. Then, if their idea was approved, they got to try it out and test it to see if it generated a positive return on investment. Most ideas were not radical—they often involved a different type of product display, moving certain products to the front of the store, adapting the product mix to the local market, pricing products differently, or combining products in a certain way. One employee, realizing that his store was in a Vietnamese community, advertised in the local Vietnamese paper, put signs in Vietnamese in the store, and dramatically improved store performance.

If the experiment worked and generated a positive ROI, it became permanent, more or less. Employees publicized their ideas on an internal intranet and presented them to other employees at innovation fairs. The results were dramatic: Lab-store performance was generally much higher than at other stores.

Unfortunately, the concept was controversial within the company. The senior executives in charge of merchandising and operations were threatened, perhaps understandably, by the idea of empowering employees to make decisions about product selection and store layout. A significant internal battle killed the lab stores, along with other innovations. A year or two later, the company found itself under attack from large online retailers and other big-box discounters; it was not agile enough to respond quickly and has struggled to regain its footing. One can only wonder how quickly the company could have adapted if tens of thousands of store-level employees had been empowered to read the situation "on the ground" and make changes quickly based on changing customer preferences and buying patterns.

These are examples of how companies can start unlocking the potential of their people, making more money for shareholders, and providing a better work environment and more pay for their employees.

Again, pay is hardly the only motivating factor when it comes to employee engagement. But any corporate initiative that aims to take the workforce to another level needs to make compensation a key element.

I advise boards of directors and their compensation committees on executive compensation, and the boards with which we work spend an enormous amount of time, money, and collective talent deciding how and how much to pay the top five to fifteen people in a company—and no time at all on how and how much to pay the other hundreds or thousands of employees on the payroll.

As noted earlier, the incentive programs developed for executives are carefully fashioned and generally work well—as they should, considering the scrutiny they get. Given the immense importance of the future productivity and pay of the American worker, perhaps boards could lend management some time and wisdom to craft plans to compensate the 99 percent. ■