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[Review of Pay without Performance: The Unfulfilled Promise of Executive Compensation]

Kevin F. Hallock
Cornell University, kfh7@cornell.edu

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[Review of Pay without Performance: The Unfulfilled Promise of Executive Compensation]

Abstract
[Excerpt] Every once in a while someone comes out with an important book concerning corporate governance or executive compensation. Like Aldolf A. Berle and Gardiner C. Means's The Modern Corporation and Private Property (New York: Harcourt, Brace, and World, 1932) and Graef S. Crystal's In Search of Excess: The Overcompensation of American Executives (New York: W.W. Norton, 1991), Bebchuk and Fried's new book is thought-provoking and interesting. It is a very important book and should be read not just by those interested in executive pay or corporate governance but by anyone interested in how corporations work.

Keywords
labor markets, personnel economics, human resources, wages

Disciplines
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Every once in a while someone comes out with an important book concerning corporate governance or executive compensation. Like Aldolf A. Berle and Gardiner C. Means's The Modern Corporation and Private Property (New York: Harcourt, Brace, and World, 1932) and Graef S. Crystal's In Search of Excess: The Overcompensation of American Executives (New York: W.W. Norton, 1991), Bebchuk and Fried's new book is thought-provoking and interesting. It is a very important book and should be read not just by those interested in executive pay or corporate governance but by anyone interested in how corporations work.

The main idea in Pay without Performance is that there has been a fundamental breakdown in how executives are paid in the United States. Bebchuk and Fried argue that most researchers of executive pay have focused on the "arm's-length bargaining model," according to which CEOs report to objective, independent board members who, in turn, report to shareholders. This standard principal-agent framework has been used in hundreds of academic papers. Bebchuk and Fried argue that empirical facts point to a very different explanatory framework—a "managerial power" model.

Pay without Performance has four main parts. In the first part the authors describe the "official view" of executive pay, the one most scholars hold. In this view, "boards, bargaining at arm's-length with CEOs, negotiate pay arrangements designed to serve shareholders' interests." In stoutly arguing that this model is not "a sufficiently accurate reflection of reality," Bebchuk and Fried marshal a long list of considerations: for example, directors seek to be re-elected to boards; CEOs have power to benefit directors (and vice-versa); boards may favor CEOs for a variety of social and psychological reasons; directors' costs for favoring CEOs are very low; and shareholders have very limited power to counteract these forces.

The second part of the book elaborates the "managerial power" perspective and employs it to explain the "unfulfilled promise" of executive pay. Bebchuk and Fried argue that CEOs use their power "to secure rents—that is, extra value beyond what they would obtain under arm's-length bargaining." Although there are many new reporting requirements for firms, managers and boards are able to "camouflage" executives' compensation. The authors cite evidence that CEOs are more richly paid when "(1) the board is relatively weak, (2) there is no large outside ownership, (3) there are fewer institutional shareholders, and (4) managers are protected from large severance packages and generous executive loans to themselves."

Part 3 continues with the "managerial power" perspective. Bebchuk and Fried argue that there is little link between pay in large American firms. In particular, bonuses are some 40 percent of pay, but this percentage is not reliable enough to be used for decision making. Bebchuk and Fried argue that empirical facts point to a very different explanatory framework—a "managerial power" model.

Part 4 discusses potential reforms that they argue improve both executive pay and corporate governance. They argue that the authors would have been more effective if they had described a coherent agenda for reform, rather than just pointing out problems. They conclude that Bebchuk and Fried have written a very important book concerning corporate governance.
LEOs are more richly paid when compensation. The authors cite soards are able to "camouflage" sorting requirements for firms, what they would obtain under "to secure rents—that is, extra ... the "managerial power" perspective. Bebchuk and Fried argue that there is little link between pay and performance in large American firms. In part, this is due to the fact that bonuses are sometimes not offered for performance, there are bonuses for acquisitions even though they may not be in the best interests of shareholders or related to firm performance, and there is generous severance given. Moreover, since stock options are not indexed to market prices, CEOs may profit handsomely just by riding a growing stock market; and options are often "re-priced" when stock prices fall and lose their incentive effects.

Although Bebchuk and Fried say that their purpose is to point out problems with the system and not necessarily to provide remedies, the last part of the book discusses a set of potential reforms that they argue would help to improve both executive pay and, more generally, corporate governance. They feel that recent reforms have done some good but that much more can be done. The root of the problem, they argue, is the failure to recognize that boards of directors need a fundamentally different set of "incentives and constraints." Central to their host of recommendations is the premise that directors are too independent of shareholders (the owners of the firm). According to Pay without Performance, little can be done about CEO pay until limits are placed on director independence, including new rules for director compensation, elections, and accountability. These types of reforms, the authors argue, would help lead to more transparency in CEO pay, and would promote compensation that is more closely linked to firm performance.

The book is exceptionally well written and clear. The authors succinctly present their main argument early on, then dedicate the rest of the book to elaborating and supporting it. If one ignores the endnotes, the reading is very smooth, quick, and easy, suiting it for a mass audience. Readers who are already familiar with the corporate governance literature are not left high and dry, however, because the extensive endnotes—497 of them following only 216 pages of text—provide plentiful details. Poring through these notes is somewhat grueling, but it is essential for anyone who wishes to evaluate the validity of Bebchuk and Fried's claims. The nature of the literature they cite in support of a given argument, for example, can itself be revealing; sometimes they refer to papers published in the best journals in economics, law, and finance, sometimes to newspaper accounts; sometimes they refer to only a part of an academic study, or to a study that is out of date in the light of recent governance reforms.

The book's main weakness, I believe, is too heavy a focus on the thesis that "managerial power and influence have shaped the executive compensation landscape." In comparing the explanatory power of the "arms-length bargaining" model to that of the "managerial power" model, the authors imply that the former is practically worthless and the latter almost full-purpose. For example, to support their claim that "boards often lower the goal posts when it appears that CEOs are unlikely to achieve their designated targets, or indeed have already missed them," Bebchuk and Fried cite anecdotal evidence and an article from the New York Times, but not convincing academic empirical support. The strain of trying to fit all relevant phenomena into the "managerial power" framework is also clear, for example, in some rebuttals of other scholars' criticisms. For example, Kevin J. Murphy argued that new CEOs are likely to have less power when they negotiate their pay package than do continuing CEOs, who may be more entrenched ("Explaining Executive Compensation: Managerial Power vs. the Perceived Cost of Stock Options," University of Chicago Law Review, Vol. 69, 2002). This is certainly a plausible and empirically testable idea. But rather than accept it and move on, Bebchuk and Fried maintain that negotiations with these new CEOs "still have deviated substantially from [the arm's-length] model." Another example is an issue raised by Brian Hall and Kevin J. Murphy in "The Trouble with Stock Options" (Journal of Economic Perspectives, Vol. 17, 2003): whereas new, stricter disclosure requirements that were instituted in the early 1990s should have slowed CEO pay growth if the "managerial power" model is correct, in fact CEO pay continued to escalate. Bebchuk and Fried counter that other circumstances that also were changing at the time (such as anti-takeover defenses) "more than offset the effect.
of better disclosure”—but they support this claim with no empirical tests.

One can easily agree with the main points Bebchuk and Fried make and with the reasonableness of several of their recommendations without being convinced that all roads lead to the “managerial power” theory. Speaking for myself, I would have found the book more persuasive if the authors had reined in their horses at certain points.

This stimulating book raises many questions that can inspire future work. For example, what accounts for the big difference in pay-setting between the United States and the rest of the world? Will the new exchange reforms make a big difference, and if so, how big, relative to the extent of the changes Bebchuk and Fried advocate? Will Sarbanes-Oxley, the 2002 act regulating corporate financial record-keeping and providing penalties for its abuse, make much of a difference in the long run?

Bebchuk and Fried’s book is important for a variety of reasons. First, it carefully articulates the difference between the often-relied-upon “arm’s-length bargaining” framework and the “managerial power” perspective. Second, it neatly organizes a wealth of new evidence on executive pay in America today. Not only do the reference section’s 257 entries comprise a comprehensive listing of important academic studies, but the authors also present scores of anecdotes illuminating the “facts on the ground”—actual CEO pay plans and corporate governance situations. Third, the book is accessible to a wide audience. Even though there have been many recent reforms in corporate governance (Sarbanes-Oxley, for example, and new regulations affecting stock exchanges), this clear, forceful book will doubtless fuel additional reforms and academic studies in the corporate governance arena. The book has helped spark many new papers already, and I feel this is just the beginning.

Kevin F. Hallock
Associate Professor
School of Industrial and Labor Relations
Cornell University

Ever since the fall of the Berlin Wall and the dissolution of the USSR, social scientists have paid increasing attention to the cross-country differences in socio-economic institutions that define “varieties of capitalism” (the term Peter Hall and David Soskice adopted for the title of their influential 2001 book) among the advanced capitalist societies. In examining the linkages between corporate governance and labor management, a distinction has conventionally been drawn between two main varieties: market or outsider systems (exemplified by the United States and United Kingdom), and relational or insider arrangements (exemplified by Germany and Japan). As Howard Gospel and Andrew Pendleton observe in their introductory chapter to Corporate Governance and Labour Management, a comparative survey of the evolving links between corporate governance, finance, and labor management is timely. First, high-profile corporate scandals have prompted a re-evaluation of the effectiveness of corporate governance arrangements and reforms, proposed or actual, in several countries. Second, in the context of the globalization of financial and capital markets, intensifying international competition in markets for products and services, and growing cross-border mobility of productive capital, the future of some national models—primarily of the relational variant—has been questioned. Put another way, whether relational systems of corporate governance and labor management are converging on the market-oriented Anglo-Saxon model has been widely debated.

This volume has two main objectives: to bring together analysis of systems of corporate governance and labor management both over time and in different national contexts (specifically, in eight advanced capitalist societies); and to explore how corporate governance and labor management interact to create distinct national configurations. In pursuing the latter objective, the contributors are alert to the impact that labor can have on corporate governance—something that is more apparent in the economies of continental western and northern Europe and Japan than in the Anglo-Saxon countries. The opening chapter also maps out more ambitious tasks. One is to go beyond the “oversimplified” (p. 14) distinction between market and relational systems to a more nu-

anced differentiation and cluster systems. In this respect, for capacity of labor to exercise influence, strong voice rights in German with its residual power to bl Stoke France, Italy, and Spain. Another which particular institution powerful effects among the previous literature has tended systemic whole, an endeavor that is less successful in realizing.

The bulk of the volume consists of country-based chapters examining governance and labor management practices between them, and contexts of France, Germany, Italy, Spain, the Netherlands, the United States, and Japan. Pendleton helpfully provides summary of each country chapter (pp. 20–30). A particular strength of the book is its account of reformed systems of corporate governance and the emergence of relational governance arrangements in States and United Kingdom, and of shareholder value in corporate management.

The final chapter, by Gregor, is comparative in focus. Basic but tantalizingly suggest of corporate governance and management based on data for 22 countries cogently discusses the methodological issues entailed in the parative venture. He concisely presents economic and sociological discussions of the problems in different (countries) where the sample compared to the potential planatory variables, many of which vary, and there is limited dispute about actual combinations values variables. In so doing, he fu

ceptual and methodological comparison fuzzy-sets method of qualitative analysis developed by Charles (Set Social Science, 2000), that combinations or conjunctures of corporate governance and labor (or outcome) variables as eit sufficient conditions: expression at board level; degree of employment protection law