Can social criteria trim fat-cat pay?

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Amidst calls to overhaul executive pay schemes, social performance could be rated to incentivize executives "intelligently."

Each year, public opinion gets inflamed with indignant media headlines like "Despite Poor Performance, CEOs Get Paid More Than Ever" and "The Great Pay Heist."

In 2007, the average CEO of an S&P 500 company received $14.2 million, for a combined total of over $7 billion. Leading the pack was Yahoo CEO Terry Semel, who raked in a whopping $71.7 million in pay, stock options and other forms of compensation. Those "other" forms often include unusual perks such as private jets, golden parachutes and lucrative sign-on packages.

As top executive pay rises, so does inequality. Each year, the gap widens between the CEO and the average rank-and-file employee, who is paid between 250 to 500 times less.

Moreover, many believe that giant incentive schemes, which overemphasize financial performance, are often to blame for bad corporate behavior, such as fraudulent financial reporting, corruption and tax evasion, along with other forms of opportunism, malfeasance and white-collar crime.

In his paper, "Pros and Cons of Rewarding Social Responsibility at the Top," IESE Prof. Pascual Berrone weighs up a new model for executive pay, one that makes social performance a leading incentive.

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Social as well as economic

Today's companies play a sophisticated role in society. Milton Friedman's classic economic view of the company - that the social responsibility of a company is to increase its profits - has evolved into a much more complex one, which struggles to balance multiple actors and conflicting interests and goals.

Companies must now respond to a variety of interest groups, including employees, customers, communities, government officials and environmental groups. For this reason, some argue that executive compensation packages should contain additional criteria that address the interests of all stakeholders, not just shareholders.

Some firms have already proclaimed a link between social initiatives and executive pay, including Procter & Gamble, 3M, Bristol-Myers Squibb and Sunoco. The proxy statements of 3M and Sunoco, for example, outline non-financial objectives, such as ethical business conduct, respect for the environment, and health and safety.

Yet, as Berrone notes, "It is hard to find more detailed information on these social criteria, such as actual measures, weights and the like, beyond these declarations of intent."

While scholars don't yet fully understand the links between social performance and executive compensation, many have argued that the right combination of short- and long-term incentives structured around social performance indicators would yield several important benefits.

After all, top managers are ultimately responsible for resource allocation pertaining to social initiatives and processes, and if they are rewarded for social performance, it would cascade down to the firm's lower levels and promote a consistent social strategy.

New pay criteria

One of the main benefits of rewarding social performance at the top is that it would stimulate managers to deploy efforts and resources towards social initiatives, which are expected to increase the firm's value.

But Berrone expresses some doubts.

First, it is not clear whether social initiatives have a salutary impact on the firm's economic performance.

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Second, it is not certain that rewarding managers for undertaking social initiatives means that all stakeholders are assumed to favor responsible actions and are thus treated in an indiscriminate way.

Third, one must consider that social initiatives are mainly driven by intrinsic motivations. Some question whether recognizing and supporting social efforts with money might actually undermine the "built-in" incentives of seeking to improve the welfare of others without receiving any personal benefit.

When incorporating social criteria into compensation packages, Berrone suggests that pay package designers should consider the following:

- Be aware of the link between social and economic performances.
- Define how social initiatives will be measured.
- Have proper information systems and monitoring mechanisms in place.
- Understand how social initiatives affect the different stakeholders of the firm and account for potential trade-offs.
- Balance intrinsic motivation with extrinsic incentives.
- Comprehend the context in which the firm operates and identify those aspects that are highly valuable within it.

A well-designed executive compensation package rewards decisions that work for the long-term interests of the company, its stakeholders and society as a whole, he concludes.

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