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Should the CEOs' salaries be capped to a certain ratio of the average worker's salaries in the same firm? Explain why.

Introduction

The purpose of this essay is to highlight the issue of excessive CEO compensation and recommend whether it is appropriate for organisations to implement a specific salary cap to prevent CEOs from exploiting their firms. The chief executive officer in an organisation is the significant designation among the board of directors and has the authority for making all corporate decisions, controlling the organisation's operations and effectively and efficiently managing its resources. CEOs are the critical drivers for long-term success and growth since they are chiefly involved in bringing innovation in the business and increasing shareholder equity; large firms will therefore offer high salaries and a significant number of long-term benefits to compensate for CEO performance (Ferry & Maber, 2003).

Over the years, the matter of CEO compensation has confronted debate from many scholars and industry experts. According to Sheikholeislami (2001), there are four components of CEO compensation; basic salary, benefits, bonuses, and deferred compensation. Each of these variables, when combined, prove to have a direct relationship with key drivers of firm performance.

Even though high salaries for CEOs reflects generous compensation for their contribution to the growth of the business, there is a wide gap between the salaries of CEOs and the salary of the average worker. Roche, a Swiss health care organisation, compensates its CEO, with a ratio of 1:236, when compared to the average salary of its lowest-paid workers. Another Swiss company in the pharmaceutical industry, Novaritis, also compensates its CEO to this great extent at the ratio of 1:219 (O'Reilly, 2014).

It would not be wrong to contend that determining whether high compensation for executives is justified, given the value they provide to the business, is very complicated. However, if companies make comparisons between the increase in compensation and a rise in stock prices, it would allow for a better argument to defend the substantial increase in pay. Alternatively, there are external factors at play which could affect substantial CEO compensation such as market trends, the position played by the board of directors as well as the ethics surrounding this issue.

Contributing factors to high CEO compensation

One dominant force influencing excessive compensation is the board of directors and their significant reliance on the CEO for promising the good performance of the business. More importantly, it could also be the CEO, demanding that they deserve high compensation since they are the head of the board of directors. Such a practice can prove to be detrimental to the interests of the business. It would also be difficult for the board of directors to condemn such practice since completing long tenures in the company; they seem unable to challenge the culture to which they belong.

Apart from this, other contributing factors include market trends and external monitoring practices. Markham (2015), shows that the practice of the board committee of Enron is to increase pay in line with that of their competitors. On the other hand, a critical tool for better evaluation of executive pay is external monitoring tools such as BAM (Business Activity Management).

A significant argument defending substantial compensation for CEOs is their contribution to the high-risk management and increasing shareholder's equity. Dunlap (1999), contends that while considering the matter of CEO compensation, it is essential to recognise the value that a CEO adds to the company for creating shareholder's equity and their compensation should be subject to trends in share prices. A connection of CEO compensation with share performance of the company is more suitable. For instance, Bill Gates compensation as the executive of the company in 2003-2004 was subject to trend in company stock price (Gannon, 2004).

However, this is not the case for most of the CEOs. For example, Bhagat and Bolton (2008) evaluated that excessive CEO compensation was one of the significant causes due to which large financial firms had bailed out after the financial crises of 2008. Moreover, according to the Wall Street Journal, in the aftermath of the financial crises, there was a different relationship between firm performance and CEO compensation. This is because even when companies experienced plummeting stock prices, their CEO had received a considerable increase in salaries and bonuses. For instance, the CEO of Cisco Systems, John Chambers, received a compensation of $18.87 million in 2010 while the company's stock price had plummeted by 31.4% (Lublin and Mattioli, 2012).

An argument supporting the idea that there should be no salary cap for CEO compensation is that CEOs bring value to the company and it is through the excellent strategic management practices that they drive the company to excel in intense competition and enhance profitability and growth. Moreover, CEOs, as leaders are also essential for creating group incentive programs that lead to high employee motivation and commitment to company interests, therefore, implementing a salary cap for executive compensation, is not appropriate.

On the contrary, there is an argument stating that if CEOs are subject to high compensation for their immense contributions, then why there is a widening gap between there and the salary of average company workers? The Gini coefficient for USA and UK, are 0.48, and 0.76, which indicates high-income inequality among workers. A significant reason for this is the increasing trend of excessive CEO compensation (Chetty et al., 2014). The Guardian (2018), reports that McDonald's CEO, Steve Easterbrook, earned $21.7m while the McDonald's workers earned a median wage of just $7,017 indicating a ratio of 3,101:1. Moreover, CEO Doug McMillon earned $19,177 in 2017 whereas, the average Walmart worker earned $19,177 in 2017, indicating a ratio of 1,188:1.

Apart from this, a problem with such high CEO compensation is that executives are being greedy and suggesting high risk-taking. According to a report from the Conference Board, in the 1990s, more than 80% of the rise in compensation for CEOs came from utilising the stock options. Therefore, compensating CEOs through stock options also results in the dilution of the company stock prices. Allocating a larger share to executives through stock options also creates a threat for financial crises for the business, and if the CEO does not perform well, he will still be receiving a generous sum of money through his share in the company stock (Murphy, 2013).

In consideration of this, it would be appropriate to develop and implement a salary cap to reduce the inequality of pay between executives and their employees. It is vital to measure critical performance metrics when considering increasing compensation. However, to do so, the organisational structure and the role of shareholders is critical. First, it would be essential to restrict CEOs from exploiting resources of the company and encourage the development of

a transparent relationship between CEO and the board of directors. Also, in regard to extending the role of shareholders regarding the compensation of board members, it is critical to comply with the provisions of the Restoring American Financial Stability Act of 2010, which gives the shareholders a non-binding to influence decisions for an increase in remuneration of workers and the board. However, such practice may prove to be ineffective, if a majority of the shareholders are members of the board. This problem could be due to giving stock options to board members as a token of compensation for their services (Krawiec, 2013).

A critical aspect of an effective salary capping system is the development of a strong link between compensation and performance measures. It would also be useful to set upper cap limits to discourage the exploitation of financial resources of the business, especially setting limits for compensating executives through stock options. Apart from this, the use of external business monitoring tools can also benefit in the following: getting data-driven insights and decision, analysing performance through the use of critical data and enhancing productivity, detect problems early and suggest suitable budget plans.

Problems with salary capping

There are specific problems with capping pay that may hinder firm performance. First, setting a salary cap to a higher level (necessary in the case of CEOs) giving less regard to performance may result in providing extreme flexibility to workers, and they may not effectively contribute to increasing the wealth of shareholders. Second, since the practice of setting caps gives less regard to performance, it is challenging to establish such caps, which are optimal. Moreover, if capping is established for the future with a marginal increase from

the current salary levels, it is very likely that employees will have decreasing levels of motivation and may not work hard due to fewer incentives. Also, the practice of excessive compensation for executives has been embedded in the global environment. If the government regulates executive compensation and enforces businesses to impose caps, it will not prove to be an active practice, since higher compensation for CEOs is also a prevalent practice among multi-national companies, who can pay equal or more than US firms. According to Fernandes et al. (2013), there is no significant level of difference between non-US firms and US firms about CEO compensation and equity-based pay.

Ethical issues surrounding high CEO compensation

Even though caps might not prove to be effective, there are indeed ethical issues and problems attached to allowing a substantial increase in pays to CEOs and stock options as compensation.

The increases in executive compensation, without good reason and giving lesser regard to performance measures, or improved stock performance is an unethical practice. The executives at the company, as the leaders of the board of directors' exploit opportunities, use financial resources of the business for their benefit, and gain other long-term benefits as well. Moreover, the role of the board of directors, who are bound to abide by the norms of the organisational culture of which they have been a member for decades, retreat from condemning such practices. The board seems to lack autonomy or sometimes, even hesitate, to raise their voices against such an unjustifiable raise in the salary of executives or may sometimes speculate among them and take higher risk for personal gains. Rosen (2002), identifies that the corrupt role of the board of directors had been the primary cause for the

collapse of Enron. The selfish nature of the board of directors resulted in Enron taking such risks of which it was not capable, resulting in the company going bankrupt.

Also, Jensen & Murphy (1990) contends that the problem is with the perception of the public, which condemns the practice of excessive compensation for executives and regards it as morally unacceptable. They are with the view that such practices have been the reason for the increase in income inequality and such a morally unacceptable widening gap between the pay of regular employees within the same company. Moreover, companies seem to lack corporate social performance. There was a positive relationship between weak social performance and higher salaries and long-term CEO incentives. The developing view in society is that it is essential to reduce the pay gap between the executives and other employees, thus hinting that corporate social performance and responsibility holds more importance than increases in profits and share prices, which become the cause for providing an excessive allowance to top executives. Moreover, pressure from the public, labour unions, and the government are likely to encourage CEOs in condemning unethical practices and raise concerns for shareholders as well (Perel, 2003).

Corruption within the board of directors

There is a serious issue regarding the role of the board of directors, those of whom usually do not consider higher compensation a problem. Over the years, the issue of excessive CEO compensation has gained significant popularity especially in the aftermath of the financial crisis of 2008 (Garner and Kim, 2010). The financial crisis of 2008 made an environment for public discussion and media questioning regarding executive compensation practices in the USA. The purpose of this investigation was to highlight the impact of the financial crisis on

compensation for executives and examine various other variables that had a link to compensation. In the study, the investigation used a sample of Fortune 500 firms and 2241 companies, which found that the financial crisis of 2008, had no significant effect on CEO compensation. On the other hand, variables such as company performance, size, and the duality of executives proved to have a unique impact on CEO compensation both before and after the financial crisis. Moreover, in another report published by AFL-CIO (2000), it was highlighted that the average CEO compensation for 200 large US corporations increased by 4.5% in 2008 whilst their stock prices plummeted to a significant low.

PPS (Pay-performance sensitivity) as a means of capping

Another key to setting a salary cap is through the adoption of a good model. The PPS model is useful for providing the incentive to employees to perform more productively to earn more. It is a valuable tool for establishing which bonuses and benefits are justified in regard to employee performance.

Even though the PPS model can support productivity at the top end of the business, it could have specific adverse effects in the long term. Brick, Palmon, and Wald (2010) suggest that by implementing PPS, managers' incentives to perform productively results in risk aversion. Managers tend to be more risk-conscious and keep themselves away from considering riskier investments; this can have an adverse effect on the future stock prices of the business. In another case, Holt and Laury (2002) observed that increased incentives appear to change risk attitudes, leading to higher risk aversion.

Prospect of market supply and demand

Apart from compensating the CEO or other workers in the company by implementing a cap, it could be more useful to consider the economic forces of demand and supply when considering their remuneration. The force of demand shows what a business can establish for a certain level of compensation against a certain level of skills, which it will need from a professional to create value for its stakeholders. The force of supply determines how many numbers of individuals in the market are talented enough and possess such competencies, which can help the company advance its growth. On the other hand, there are only a few numbers of talented individuals in the market, who can replace the current top executives. This is how the force of demand and supply successfully establish an equilibrium regarding the level of compensation for executives.

Considering the widening gap between the pay of executives and salaries of the average workers of the same firm, it would be useful to cap the salaries of executives to a specific ratio of the average worker's salary of the same firm. It could also be helpful to assess the current salaries of the workers, keeping in view the prevailing market pay rates for the worker of the same designation and industry.

Alternative solutions to capping CEO salaries

Taking into account the issues surrounding the capping of CEO salaries, it is useful to consider alternative solutions such as altering the procedure for the selection of the board of directors and adopting the use of a qualified external monitoring system.

A suitable course of action in order to reduce corrupt practices within the board of directors would be electing those to the position of board of director, who do not share a history with the CEO of the business. This can prove to help in matters where CEO's exploit the resources of a business for self-interest, and where an increase in salaries and other benefits is not justified with performance levels and concerning equity pay per share.

The implementation of an externally qualified monitoring system allows for an analysis of performance on different dimensions and consultations in regards to the compensation of employees. Furthermore, executives of big corporations' benefit from the practice of making possibilities for foreign investors to become shareholders of the business. Choi et al. (2007), identifies that foreign investors in a company have more of a significant impact in increasing firm values than its domestic investors.

Conclusion

It would not be wrong to contend that the practice of granting excessive compensation to top executives concerning substantial salaries and stock options, without giving due regard to performance levels and productivity, is wrong. The role of the board of directors is critical also critical to consider. There should be a demonstration of a more transparent relationship between the CEO and board of directors to all critical stakeholders (employees and investors). Furthermore, developing such a wide gap between the pay of top executives and employees of the same business is not in any way morally acceptable. It is important to reduce such inequality of income distribution primarily in the case of the United States, where the ratio of an average CEO's compensation has surpassed 100 when compared to the salary of an average worker of the same company. However, this practice has proven to be

ineffective since stakeholders, the board of directors and top executives are not motivated to adopt a change and condemn this practice. The argument presented by them is that the senior executives' level of understanding for strategic management techniques and their role in bringing innovation to business while creating group incentives for the workforce (increasing motivation) results in creating value for the business and increasing shareholder's equity to a significant level (Krawiec, 2013). This notion of a high level of compensation for executives provides them the incentive to take greater risks and draw out the attention of investors, which would not be possible if compensation is based on capping. Their compensation is justified for the value they bring to the business. Therefore, it would be wrong to say that CEOs' salaries be capped to a certain ratio of the average worker's salaries in the same firm.

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