

Overcompensation: CEOs and corporate greed

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Ten years ago, even five years ago, the American market economy was the model for and the envy of the world. The marvelous flexibility of our economy, our belief that “change” is a good word, our constant striving for innovation were and are factors that make ours an economic system that can compete with—and beat—any other.

And yet, in the Sarbanes-Oxley Act of 2002, the Congress and the president created a law that was revolutionary in the changes it prescribed and the activities it proscribed in our capital markets. It ruled that officers, directors and auditors of publicly traded companies must take new responsibility for the accuracy of the companies’ financial reports and face stiff penalties for failing to do so.

How could that have happened? I believe it happened because in the course of the 1990s, many American business leaders got confused and their moral compasses stopped working.

It is particularly sad that such confusion took place at a time when U.S. businesses were responding in a brilliant way to a very serious challenge. Globalization of the world economy became much more intense in the 1990s, and American companies lost pricing power. It is easy to see why a manufacturing firm in Chicago cannot increase prices if it has to compete with firms in Mexico, China, India and other countries with dramatically lower labor costs. But service firms discovered that they had the same problem. You cannot raise prices for, say, a call center in Naperville if you are competing with call centers in New Delhi. Only very local services, such as health care and legal services, have been immune from this globalization-driven loss of the ability to raise prices.

If you cannot raise prices, and if wage pressures are fairly intense because of the kind of tight labor market we had in the 1990s, the only way to fund the wage increases without reducing profits is to improve labor productivity.

U.S. businesses solved their problem of loss of pricing power but rising wages by investing in information technology to run their businesses more precisely. Investing in IT was just the beginning. The way of doing business also had to change.

Retail trade is an obvious example. In a modern store, you check out and each item's bar code tells the clerk what it costs. More important, the same type of information system updates the inventory records and the order book when the inventory hits a level indicating that it is time to reorder. In contrast to an earlier era, you do not need clerks to keep inventory records and you do not need large warehouses (because we copied the Japanese just-in-time delivery system previously used only in manufacturing). Also, there is a saving on the cost of financing now-reduced inventories. These and similar systems not only financed higher wages for workers, but increased profits substantially.

This was an effective response on the part of American business executives. They deserved credit for it. But it perhaps was a factor in their moral confusion. Pundits told them it was a new economic era, and the excitement went to their heads in a variety of ways.

Two things stand out: executive compensation and the drive for ever increasing and fully predictable quarterly profits.

In 1980, the average large-company chief executive officer made 40 times more than the average employee in his or her firm. Let's assume that the multiple made sense because of the extra preparation, the risk-taking ability, and the leadership skills required of CEOs.

By 2000, the multiple of the average CEO's pay over that of the average worker in the firm had risen, according to some studies, to 400 times. So in the course of 20 years, the multiple of CEO pay went up by a factor of ten. There is no economic theory, however farfetched, which can justify such an increase. In my view, it is also grotesquely immoral.

I should also note that I knew a lot of CEOs in 1980, and I can assure you that the CEOs of 2000 were not ten times better—if any better at all.

Now let's look at earnings performance. During the 1990s corporate America developed a habit of predicting quarterly earnings—something accomplished by the people in the financial management of public companies guiding allegedly

independent investment analysts to a consensus on how much the company would make in the next quarter. That morphed into a string of predictions of ever rising quarterly profits.

In this time of confusion, if a company achieved what it forecast, the CEO—he or she making 400 times an employee's income—was truly a genius. If the forecast was missed by underperforming, the genius was regarded as a fool and his or her tenure was questioned by the pundits of the investment banking community and the financial press.

What was really going on in response to this self-created situation was that companies were cooking the books, with the help of outsiders such as lawyers, investment bankers, commercial bankers and, yes, accountants and auditors.

When the tech bubble broke in the second quarter of 2000 and the large market correction began, the half of American households invested in the stock market started to notice that their retirement plans and mutual funds were losing value. They were unhappy, but they were not sure whom to blame.

The ensuing scandals let them know whom to blame: corporate executives. Lest anybody think it was just Enron, WorldCom, HealthSouth and a few others, financial implosions were happening with sufficient rapidity to make the American citizenry very angry.

In a democracy, when voters get angry, they let their elected representatives know just how angry they are. Congress and the White House responded with the Sarbanes-Oxley Act of 2002, passed by overwhelming majorities in both the Senate and the House of Representatives and signed by a president who called it the most important securities legislation since 1934.

Let us stop for a moment and ask ourselves why the Congress, the president and the American people did not decide that the scandals involved just a few bad apples in an otherwise healthy business community. The reason: the widespread executive greed and the cooking-the-books phenomenon. The people thought that the business leadership in general needed a sharp lesson.

My impression is that many business executives think this is a bad dream that will soon go away. They are wrong. The American people are still angry and the politicians know it. I am told by friends on the Hill that their mail runs very heavy

indeed from constituents strongly protesting the continuing excesses of executive compensation.

What should we be doing? We need enough CEOs and their boards—preferably those of the very strongest companies—who will inform the world that they wish to be judged on performance over time, not just yesterday or tomorrow. Lots of people will argue that it will be impossible to judge performance over time—and it may take a while before the markets will adjust to a new, more rational management approach—but we must take the risk and move in that direction. Private business leaders will have to show the courage to do it.

Is there some compass that should guide us? I think there is. My friend Kofi Annan in accepting the Nobel Peace Prize pointed out that at the center of all of the great religions is each person's responsibility for others. Such responsibility is at the very heart of the Torah. In Christianity, it is dramatized in the Gospel of Matthew when a Pharisee asks Jesus which is the greatest of the commandments. He answers that there are two: the first is that we should adore the Lord our God. The second, equal to the first, is that we must love our neighbors as ourselves.

Does a CEO making 400 or 500 times more than the average employee not consider fellow workers to be neighbors? When we think of the community around us, are not those less fortunate than we—the homeless, the orphaned, the uneducated—our neighbors? What, after all, is the biggest difference between a homeless person on a windy corner and you and me? My answer is that I was luckier. When I look at such a person I do not swell with pride, but think that “there but for the grace of God go I.” That person is my neighbor.

If once a week, when we are at our place of worship, or just sitting and thinking, would we not be better people and better leaders if we examined ourselves this way? In the past week, has everything I have done been moral, as opposed to legal but just within the outer limits of the law? In the next week, will everything I do be morally sound? We do not need theologians to guide us. Simply knowing that we should love our neighbors as ourselves is sufficient guidance.

This article is adapted from a speech William J. McDonough delivered at a meeting of the Economic Club of Chicago in 2004.