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**Directors' Remuneration: The Need For a Geo-Political Perspective**

**by**

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## Directors' Remuneration: The Need For a Geo-Political Perspective

*There are many ways to construct an incentive program. However, most compensation plans tend to be focused on profitability and profitability-related accomplishments with little or no incentive for corporate social responsibility. Director's compensation continues to climb with the United States leading and Britain following modestly behind. The question as to where fair pay ends and over-compensation begins - and what that means for the community - is rarely raised. In order to understand the impact of fair and over-compensated director's pay on other stakeholders, a geo-political perspective is proposed that builds on knowledge of existing theories of the firm.<sup>1</sup>*

**Key words:** Directors' remuneration, geo-politics of executive pay, executive pay structures, executives' pay models, executive pay incentives.

### Introduction

The debate on toil, what it is and what it is worth pre-occupies scholars and practitioners alike. The historian, Thomas Carlyle, argued that 'all true work is *sacred*' (Carlyle, 1999: 206). In contrast, his contemporary philosopher, John Stuart Mill, held that work 'is not good in itself as there is nothing laudable in work for work's sake' (Mill, 1998). The benefit to be gained from work is that of compensation and it is this latter view that has captured the limelight. The last two decades have been dominated by the corporate mantra of 'shareholder value' and rising remuneration packages for executives (Frederick, 1986). At the same time, the remuneration of directors is one of the most intensely researched and, perhaps, least understood areas of management. The director's remuneration phenomenon attracts concern and emotion from shareholders, employers, politicians, the press and global stakeholders. Although a number of longitudinal studies (O'Reilly *et al*, 1988; Main *et al*, 1995; Buck *et al*, 2001) and empirical surveys (Abowd and Kaplan, 1999; Camp, 1989) have attempted to explain the interaction between remuneration structure and company performance, very little has been done to explain the remunerator's magnitude, structure and sensitivity to the long-term impact on stakeholders and wider community (Bowen, 1953). The scholarly debate primarily focuses on the company director's remuneration incentives with only an occasional mention in the popular press of the growing divide between the 'haves' and the 'have nots'. Particularly, the debate over executive directors' remuneration has focused on three aspects of the remuneration package, namely:

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- the magnitude of basic remuneration and reward increases;
- the structure of remuneration, with a focus on the large gains from share options and the compensation payments to directors on loss of office; and
- the sensitivity of the remuneration incentive to share price performance.

This paper provides an overview of the current debate and theories that attempt to explain directors' remuneration. Attention is given to Agency, Economic and Socio-Comparative approaches and underlying theories (Coase, 1960). It is concluded that although a number of theoretical perspectives provide some explanation of the phenomena, none truly explain it (Ackerman and Bauer, 1976). It is argued that a geo-political perspective is required, namely one that takes into account the impact on community needs in determining these factors (Chamberlain, 1973; Carroll, 1979). A geo-political model is presented, concluding that broader inter-disciplinary research is needed in finding solutions to the complex issue of directors' remuneration integral to corporate governance and the global community (Coase, 1937).

### **The Agency Approach**

Since its conception, Berle and Means' (1932) Principal-Agent model underpins the philosophy of the modern theory of the firm and many models of corporate governance, including that of executive compensation (Ratneser, 2000). Providing incentives to managers of publicly-owned companies is the classic example of the Principal-Agent challenge that assumes that the primary means for shareholders to ensure that managers take optimal actions is to tie managers' pay to the performance of their firm; in effect to provide incentives for managers to maximise returns to shareholders (Berle and Means, 1932). Pursuing such a linkage is considered to align the interests of managers with the interests of shareholders.

Considering that executives take non-transparent and unobserved actions that affect returns to shareholders, Principal-Agent Theory suggests that executive compensation needs to be correlated with the total return to shareholders, typically through ownership of the firm's stock or options on the firm's stock. However, despite the compelling logic of the Principal-Agent framework, there is little existing

empirical support for the effectiveness of the Principal-Agent model when applied to executive compensation. Using pay-performance sensitivity measures, a number of empirical studies are unable to support the executive reward/corporate performance linkages underlying the Principal-Agent model (Jensen and Murphy, 1990; Janakiraman *et al*, 1992; Garen, 1994; Haubrich, 1994; Aggarwal and Samwick, 1999). In general, these studies found that the pay-performance sensitivity for executives at firms with the least volatile stock prices is an order of magnitude greater than pay-performance sensitivity for executives at firms with the most volatile stock prices (Aggarwal and Samwick, 1999). Overall, a number of empirical studies (Barro and Barro, 1990; Janakiraman *et al*, 1992) have found that compensation increases according to industry performance. However, the agency perspective holds that the remuneration contract should be used to align the interests of the director with those of the shareholder and such thinking has underpinned many regulatory committees in this area (Jensen and Meckling, 1976). For example in the UK, the Cadbury (1992), Greenbury (1995) and Hampel (1998) Committees have taken this perspective.

Overall, agency theory predicts that the separation of owners and managers potentially leads to managers of firms taking actions, which do not maximise shareholder wealth (Jensen and Meckling, 1976). Such action may include excessive salaries for directors not tied to performance or them undertaking value-destroying mergers. The agency framework suggests that internal monitoring mechanisms will help to ensure that directors implement policies consistent with the maximisation of shareholders' wealth. These include non-executive director representation to monitor board decisions, separation of the chairman and chief executive posts and the establishment of board sub-committees.

### **The Economic/Market Approach**

The dominant model of the firm continues to be of Neo-Classical Theory derived from Adam Smith's (1937) idea of the relationship between producers/owners and consumers, where the under-pinning theme is market forces and rationality (Friedman, 1962). Thus, economic values guide choice and choices are rational and utility maximising. In Neo-Classical economic theory, the goal of Smith's (1937) Economic Man is to maximise the wealth of the firm and is based on contractual duties owed to owners (Brenner and Cochran, 1991). The main assumption is that the only duties the firm has to external others

are financial and these duties are owed to the owners which, in the case of modern corporations, are shareholders (Brenner and Cochran, 1991).

Moreover, in order to resolve agency tensions, external control mechanisms such as market competition and internal control mechanisms such as corporate governance, are mostly utilised. In order to enhance internal controls, improvement of corporate governance has been interpreted as increasing the number of external directors with them being attentive to corporate direction and control; exemplified by pension fund activism (Branceto, 1997). Market mechanisms are left to supply and demand for goods and services and price competition for the delivery of goods. The economic approach uses a subset of Contract Theory and Agency Theory to explain and predict firm behaviour; notably that managers act as agents for stockholders/principals.

However, the market/economic perspective is increasingly being criticised. One view is that markets are social constructs that need support to survive and prosper. Top executives do not generate wealth by themselves; they do so against a backdrop of social institutions and human capital. Is it then fair and legitimate that the market should set the terms on which the few can accumulate wealth? (Prowse, 2000).

An additional perspective is that globalisation and information technology (IT) have increased the importance of worldwide factors in steering share prices, often at the expense of local country factors. On this basis, individual stock markets are increasingly being driven by global, rather than local, factors (Brooks and Catao, 2000). The increased mobility of capital, combined with more efficient trading systems, under-pinned by the advance of IT, has increased cross-border trading of shares, creating something closer to a global equity market (Brooks and Catao, 2000). With the proliferation of Internet-based technology, it has become both increasingly easier for investors to acquire information on foreign firms and for large corporations to be listed on more than one market. In addition, the wave of cross-border mergers and acquisitions results in overseas profits accounting for a larger slice of company performance. The fact that an enterprise belongs to a particular industry, be it pharmaceuticals or utilities, has become more important in explaining variations in returns on investment, over time, than the enterprises' home country market (Brooks and Catao, 2000). The question raised is, how can current levels of executive pay be justified when the transformational element of a CEO's role is minimised and the transactional component accentuated? (Kakabadse and Kakabadse, 1999).

### **The Social Comparison Approach**

The social comparison perspective explains firm behaviour by integrating observed social performance with observed economic performance (Sethi, 1975; 1979). In addition, the comparison perspective builds on Socio-Physiological and Legitimacy Theory, emphasising, for example, role expectations and role behaviours (Katz and Kahn, 1978; Biddle, 1986) and roles as determinants of social position and organisational status (Biddle, 1979; 1986). Moreover, the concept of role sets (Merton, 1957) and concepts of organisational sets (Evan, 1966) are identified as the underpinnings of Stakeholder Theory (Freeman, 1984). The social comparison perspective holds that the magnitude and structure of executive remuneration can be determined by comparisons of observable performance of directors across industries (Heald, 1970; Jones, 1995). It assumes that the members of an organisation's remuneration committee, composed of non-executive directors, form opinion and approve the magnitude of directors' remuneration by making comparisons with their own executive roles and remuneration in their home organisation (Bender and Porter, 2001a; 2001b; 2001c). Ironically, such personalised views of executive remuneration are being favourably received as over-relying on surveys of executive compensation encouraging a type of 'group-think' such as everyone is doing it, so should we (Power, 1991).

Moreover, directors who are at the receiving end of remuneration also make comparison with the remuneration of other directors in similar situations to themselves, invoking role expectations and equity perceptors which enable them to make a choice to stay with the enterprise or to seek alternatives (Merton, 1957; Evan, 1966). These two sets of external peer comparison act as an anchor in determining an appropriate level of pay (Hosseini and Brenner, 1992). Similarly, the social comparison perspective suggests that the structure of pay will be based on structures successfully adopted by other companies, finding support in Institutional Theory (DiMaggio and Powell, 1983) in order to legitimise the actions of the home community, as suggested by Legitimacy Theory (Davis, 1973).

## Overview of Director's Pay

Considering that executive directors do not realise their vision of ever improving share performance in the market place alone but depend on internal stakeholders, such as employees and suppliers, and on the external stakeholders, such as legal and financial institutions and governments in the economies of their operations, it is illuminating to compare directors' pay with those of Heads of State (Table 1). The question of what is 'fair' reward is a long debated one. Plato (1991) reasoned that the 'right ratio' between the top and bottom is 5:1. Peter Drucker postulated that it should be 20:1 (Wagner, 1999). The norm in Continental Europe and Japan is a multiple of 18 and 15 (Table 4), whilst in Cyprus and China the ratio is 3:1, respectively (Kakabadse and Kakabadse, 2001). In the USA, the gap between executive pay and average pay is continuously increasing. The CEO of AT&T earns 400 times what the lowest-paid employee earns (Wagner and Minard, 1999).

**Table 1: Basic Pay For CEOs in Medium -Sized Enterprises and Head of States (in USA Dollars)**

<b>2001 Basic Annual Pay (excluding add-ons)</b>	<b>USA</b>	<b>UK</b>	<b>Japan</b>	<b>Germany</b>	<b>Sweden</b>	<b>France</b>
<b>Estimated average for CEOs in medium-sized enterprises (2001)</b>	530,000	305,000	310,000	210,000	190,000	240,000
<b>Government Head of State (2001)</b>	400,000	225,000	195,000	150,000	105,000	100,000

**Source:** Compiled from Towers Perrin (2002); Japan Information Centre (2002); and *Time* (2001)

One reason for such disparities in the USA is that since 1994 there has been a large increase in the use of stock options and other incentives to provide for CEO compensation and incentives (Table 2). In addition to being an important component of CEO compensation, stock options are also a critical consideration towards CEO equity incentives. Research shows that the options balance in CEO annual pay varies across industry groupings, whereby in 'new economy' firms (e-high-technology) equity based compensation substantially exceeds that provided in the longer 'old economy', manufacturing and utility firms (Ittner *et al*, 2001).

**Table 2: Remuneration Magnitude and Structure of CEO's Estimated Average Package in Medium-Sized Enterprises (in USA Dollars)**

Estimated Average CEO's Pay (2001)	USA	UK	Japan	Germany	Sweden	France
<b>Basic Pay</b>	530,000	305,000	310,000	210,000	190,000	240,000
<b>Plus add-ons:</b>	1,403,000	364,00	198,000	245,000	224,000	279,000
• <b>Variable bonus</b>	Yes	Yes	Yes	Yes	Yes	Yes
• <b>Compulsory company contribution</b>	Yes	Yes	Yes	Yes	Yes	Yes
• <b>Voluntary company contribution</b>	Yes	Yes	Yes	Yes	Yes	Yes*
• <b>Pre-requisites</b>	Yes	Yes	Yes	Yes	Yes	Yes
• <b>Long-term incentives</b>	Yes	Yes	Yes*	Yes	Yes	Yes
<b>Total Pay</b>	1,933,000	669,000	508,000	455,000	414,000	519,000

**\*A new add-on introduced in 2001, which was not previously used.**

**Source:** Compiled from Pic (2001); Towers Perrin (2002)

Similar to the USA, senior executive remuneration in the UK has increased dramatically and more so than their counterparts in medium sized enterprises (Table 2). In 1999, top British executives were paid an average of US\$1,004,000 (£717,000) in which was included a long-term incentive scheme (Prowse, 2000). The impetus for a shift in the structure of directors' pay, in the UK, occurred in 1995 with the publication of the *Greenbury Report* (1995), which recommended principles for director remuneration in relation to accountability, transparency and linkage to performance. Until 1995, Unconditional Executive Director's Share Option schemes (ESOs) were prevalent (Conyon and Murphy, 2000), allowing executives to purchase company shares in the future at current prices thus giving them every incentive to raise share price.

The initial ESO structure was scoped in the 1980s in the USA and diffused across UK companies. As a result of bull markets and regardless of the quality of their decisions, many executives reaped large gains although they chose to invest their resources in shares and in transactions openly available to all

investors at the time of the options award (Economist, 2001; Time, 1999). This gradually attracted media criticism, leading to tighter regulation by government and self-regulation by the Stock Exchange, accountancy professions and institutional investors (Blundell and Robinson, 2000). In turn, more open disclosure of detailed operations of adopted remuneration instruments ensued. Greenbury (1995) recommended that companies replace ESOs with more challenging performance criteria, conditional share options (CESOs) and/or long-term incentive plans (LTIPs). The LTIP is effectively a CESO, with a zero exercise price, thus, making no demands on the executive's own finances. Both CESOs and LTIPs can be seen as different forms of remuneration share-based schemes and are often valued using one of three available valuation models, namely, the value of options issued during a given accounting year, or the cost of all options as if they were 'immunised' by the company thus holding identical value in the market, or 'full cost' covering the change in the value of all outstanding options plus the cost of the exercised options during the year (McKnight and Tomkins, 1999).

By the end of 2000, in the UK, the average FTSE 100 CEO earned £1.7 million (Patterson and Jauhal, 2001). The payouts of £14 million one-off share bonuses to Chris Gent at Vodafone AirTouh, initially announced as the reward for successful acquisition, provoked not only media attention in the UK in 2000 but also concern amongst institutional shareholders (Kennedy, 2000). In addition, the structure of Gent's remuneration incentive consisted of seven schemes without clarity or guidelines about the circumstances under which these incentives would be paid (Myners, 2001).

Considering that Gent had spent almost £200 billion on the Mannesmann acquisition – the equivalent of about a quarter of the UK's GDP in the space of two years, and in the light of last year's fall of share price from a high of 399 pence to less than 150 pence, it means that Gent spent £200 billion to create a business worth £100 billion – an extreme case of value destruction (*The Week*, 2001). Moreover, in 2001 Vodafone's award of £8.0 million share options – potentially worth nearly £13 million to Gent over the next five years, provoked discontent amongst stakeholders (*The Week*, 2001). Similar concerns were expressed about the £2.8 million payment to Bob Ayling for quitting as CEO of British Airways in the wake of slump in profits (Kennedy, 2000). Further, the pay of executives in the utilities sector rose 106% compared with total shareholder return (TSR) for the year of 30% (Patterson and Jauhal, 2001). Ayling and Gent are not exceptional cases as it has become more commonplace for director reward to outstrip

company performance in terms of shareholder return (Table 3). In the UK, it is increasingly being held that rewarding executives with shares rather than options is fairer, a view that is increasingly becoming popular in the USA (Patterson and Jauhal, 2001).

**Table 3: Rewards Versus Performance of FTSE 100 in 2000**

<b>Total Shareholders Return</b>	<b>Above 40%</b>	<b>20%-40%</b>	<b>0%-20%</b>	<b>Below 0%</b>
<b>Director's Wealth Increase</b>	121%	69%	23%	-20%

**Source:** Compiled from Patterson and Jauhal (2001)

A strong emergent opinion is that driven by shareholder interests, executive management is focused on short-term objectives in creating, or at least maintaining, high share prices at the expense of other stakeholders, particularly internal stakeholders (Kakabadse and Kakabadse, 2001). As a result, a serious division is emerging in society between those few rich and the vast majority on 'average' pay. Executive pay in the USA considerably adds to such division than that of their counterparts in Europe and Japan (Table 4). The difference is considerable even in small and medium-sized companies and in the large corporations, considerably higher. In 1997, the top executive's average remuneration in the USA was 325 times the average pay of the shop floor worker. In 2000, it was 523 times as great, whilst in 2002 it was 600:1 (Kochan, 2002). The average remuneration of a UK chief executive was 18 times more than the average worker and 20:1 in 2002 (Taylor, 1999; Institute of Policy Studies, 2002). The ratio of 20:1 is the highest ratio in the European Union, whilst the average pay of French chief executives is 12 times that of the average operative (Kakabadse and Kakabadse, 2001).

**Table 4: Pay Ratio of CEO and Workers**

<b>Year</b>	<b>USA</b>	<b>UK</b>	<b>Japan</b>	<b>Germany</b>	<b>Sweden</b>	<b>France</b>
1997	325:1	18:1	15:1	13:1	11:1	12:1
2002	600:1	20: 1	15: 1	14: 1	11:1	12:1

**Source:** Kakabadse and Kakabadse (2001); Institute of Policy Studies (2002); Japan Information Centre (2002)

According to the Report by the Institute of Policy Studies and United For a Fair Economy (2001), the average pay of the CEOs of 365 major corporations in 2001 was US\$13.1 million, which is a 571% increase on the early 1990s. However, the average factory worker's annual pay was US\$24,668, which in 2001, if it had grown at the same rate as CEO pay, would be more than US\$120,000. In the same vein, if the minimum wage of US\$3.80 in 1990 had grown at the same rate as CEO pay, (571%) it would, in 2001, be US\$25.50 an hour, rather than US\$5.15 an hour (IPS/UFFE, 2003).

As the gap in the USA between executive pay and average operative pay continuously increases, the escalated pay of star CEO 'performers' also propagates disparities in pay for second- and third-tier executives. In the UK, the traditional limit of 50% difference between CEO remuneration and his/her direct associates has long gone. The gap is widening (Myners, 2001). Research conducted by the actuarial firm William Mercer, found that the average value of share options awarded to senior executives in blue-chip companies had doubled over the previous year (Kennedy, 2000).

Whether such a state of affairs will continue has been thrown into doubt as in January 2003 the UK's FTSE 100 Index fell by 143.4 points wiping out £700 billion from the value of stocks and representing a drop of 50.2% from the share value peak of 1999 (Paterson *et al*, 2003). With such decline in value, activist shareholders are increasingly not accepting 'fat cat' pay packages. Most notable has been the rejection of the remuneration policy of GlaxoSmithKline, in particular, the package of its CEO, Jean-Pierre Garnier (Foley, 2003). Predictions are being made that shareholders will, from now, actively target director's pay, with HSBC, ICI and Tesco reported as the next to undergo scrutiny over 'payment for failure' in boardrooms (Griffiths and Wough, 2003). In fact, the 'first shot across HSBC's bows' has already been fired with the public display of shareholder unease concerning HSBC's new board member, William F. Aldinger III's three year, US\$37.5 million package (Gibson, 2003). Although John Bond, HSBC's chairman, successfully defended Aldringer, such resentment is being directed towards legislators, where, in particular, Patricia Hewitt, the UK's Trade and Industry Secretary, is currently preparing a paper on approaches to curbing excessive boardroom remuneration awards (Borris and Arndt, 2003).

Overall, the investor initiative to curb senior executive pay is gaining momentum (Borras and Arndt, 2003). Union and public pension funds are capitalising on investor irritation concerning inflated remuneration and bankruptcy-proof retirement executive packages, particularly in poor performing companies. Proxy based resolutions have made an impact on a number of large corporations, Delta, Bank of America, Norfolk Southern Corp, in terms of curbing excessive stock options and ‘golden parachute’ severance packages (Borras and Arndt, 2003). Although shareholder resolutions are not binding on management, the new willingness by mutual funds and other institutional investors to vote against management is increasingly persuasive in requiring shareholder approval of CEOs pay and severance packages (Covlin, 2003).

### **Executive Incentives**

Despite the USA Federal Reserve Chairman, Alan Greenspan, echoing continental European counterparts in warning against stock-option excesses, the performance-based executive composition package inclusive of incentive pay and stock options, has remained (Amihud and Lev, 1999). Further to the inequities and the ensuing political repercussions, an additional reason for caution is the enhanced propensity to take risk, thus counteracting the ‘natural’ managerial tendency toward risk reduction (Amihud and Lev, 1999). The executive incentive for risk taking leads to increased mergers and acquisitions and above normal market earnings to shareholders which, in-turn, promote increased individual earnings to executives with the danger of giving minimal attention to sustainable growth (Amihud and Lev, 1999). The assumption that the reduction of agency costs through the separation of ownership and control can be mediated by the involvement of institutional investors and board composition, is being increasingly challenged (Amihud and Lev, 1999). Ever higher executive pay is not necessarily the best way for reducing agency costs and, additionally, falls short of considering other stakeholders. Thus, executive share ownership and share option payments hold asymmetrical risk properties according to the idiosyncratic response of each executive and the consequent different effects on corporate resource allocation decisions (Table 5).

**Table 5: Shares and Options**

<b>Factors:</b>	<b>Shares</b>	<b>Share options</b>
Potentially most valuable when exercised during:	Predictable market	Volatile market
Dividend payments	Yes	No
Expense against profit	Yes	No
Taxation treatment	Double taxation	Tax benefit
CEO behaviour	Risk avoidance	Risk taking, potential abuse

**Source:** compiled by authors

For example, the Sanders (2001) study of 250 firms from Standard and Poor's 500 (S&P 500) which examined the effects of ownership and option pay, reveals diametrically opposite effects on firm acquisition and divestiture propensity. In addition, the study shows that contextual characteristics moderate the risk-seeking behaviour associated with ownership. Share options may be motivational as they offer upside potential without imposing real downside risk on those who receive them in their compensation plans (Sanders, 2001). Hence, options lead executives to take risks that shareholders might otherwise avoid, as executives view the potential future payout associated with option pay as a form of compensatory lottery (Sanders, 2001). They engage in the acquisition, divestiture and other risk activities and strategies to increase the probability that the share option compensation 'lottery' will pay off.

Additional to risk taking incentives is that the structure of the Anglo-American model of corporate governance favours hostile take-overs, thus threatening executive management's jobs as well as the jobs of employees. The impact of this model of efficiency achievement coupled with the drive to increase shareholder value acts to the detriment of employees, even if they manage to keep their jobs. The affected employees may perceive the prospect of acquisition and mergers, or even outsourcing, as being contemporary 'serfdom'; being sold-off, often with capital equipment, in a manner similar to land in Imperial Russia being sold-off with its 'serfs' (Kakabadse and Kakabadse, 2001). With 'new ownership' and 'new management', employees often feel that they have been betrayed to the principle of economic efficiency. Additionally, over time, executives can gain additional power by controlling the information revealed to other stakeholders (Walsh and Seward, 1990). For example, the close relationship between

warranted value and market value tests the ability of investors to ferret out appropriate information and process it quickly to arrive at pricing decisions (McTaggart *et al*, 1994). Thus, information concerning the financial health of the organisation can be manipulated affecting the warranted value of a company's shares. Where the CEO is the founder or occupies the dual role of CEO and president, the strategic planning and resource allocation processes (key institutional value drivers) may be unduly over influenced by that single executive (Bebchuk *et al*, 2002; Compb and Skill, 2003). With the increase of CEO influence emerges the propensity for excessive pay rises irrespective of stock performance (Bebchuk *et al*, 2002; Compb and Skill, 2003). The Compb and Skill (2003) study indicates that shareholders bear the cost of excessive pay when an executive has notable power. Such was the case with Tyco's CEO and CFO who, in 2002, earned US\$136 million and US\$82 million respectively whilst the company's stock slid by 71%. However, Tyco is only one example of many (Table 6).

**Table 6: CEOs Compensation and Shareholders Return**

<b>Company</b>	<b>Total CEO Compensation (2002) millions</b>	<b>Shareholder Return (2002)</b>
Apple Computers	US\$78.2	-34.6%
Lucent Technology	US\$38.2 (base salary) Plus package	-75.4%
Sun Microsystem	US\$31.7	-74.7%
Tenet Health Care	US\$35.0	-58.1%
John Hancock Financial Services	US\$34.3	-31.7%

**Source:** Burke and Schollser (2003)

It is interesting that at the time of emergent market decline, the 52 CEOs who laid off 1,000 workers or more took, on average, US\$23.7 million, a full 80% more than the average CEO in the top 365 group (Longworth, 2001). Amongst these were Disney's CEO, Michael Eisner, who earned US\$72.8 million in 2000 whilst laying off 4,000 workers, American Express's Harvey Golub, whose pay rose by 22% while he laid off 6,600 workers and Cisco Systems' CEO, John Chambers, who made US\$28.7 million, in 2000, including a 40% pay increase, while laying off 8,5000 workers (IPS/UFFE, 2001; Longworth, 2001).

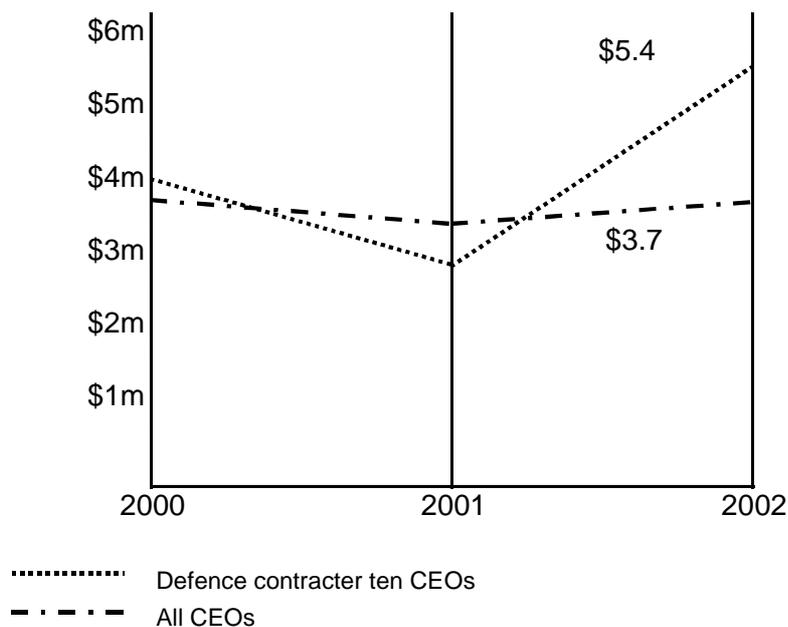
**Table 7: Fortune 500 Companies**

<b>Fortune 500</b>	<b>Year 2000</b>	<b>Year 2001</b>	<b>Year 2002</b>
Total Revenue	7.2 trillion	7.4 trillion	7 trillion
Total Profit	443.9 billion	206.2 billion	69.9 billion
Total Reported Loss	18.1 billion	148.5 billion	295.7 billion
Companies reported losses	53	97	120

**Source:** Compiled from Fortune (2003)

In contrast, at the height of the bear market, (Table 7) the median top executive pay rose by 32% for chairmen and CEOs, 10% for senior financial analysts and 6% for CFOs (Useem *et al*, 2003). In contrast, some of the more spectacular pay rises have occurred in the defence industry. The median CEO pay for the 37 largest defence contractors including Lockheed Martin, Boeing, Raytheon, Northrop Grumman, and General Dynamics, rose by 79% (Fig. 1; IPS/UFFE, 2003). Median top executive pay was 45% higher in 2002 at defence contractor enterprises than at the 365 large companies surveyed by Business Week Magazine (IPS/UFFE, 2003). The jump of USA defence contractors CEO pay far exceeded the increase in defence expenditure, which rose 14% from 2001 to 2002 (IPS/UFFE, 2003).

**Figure 1: Median CEO of USA's CEOs 2000-2002**



**Source:** Adopted from IPS/UFFE (2003)

The study also reveals that the size of political campaign contributions by the largest defence contractors is strongly correlated with the value of defence contracts awarded to that company (IPS/UFFE, 2003). The study indicates that 90% of the difference in contract size can be explained by size of contribution (IPS/UFFE, 2003). However, the entanglement of business and politics is not new. Intermingling was first revealed with the South Sea bubble collapse in August-September 1720, when a parliamentary inquiry found that the company books were largely fictitious and that many MPs and government officials had accepted bribes from the company's directors (Paterson *et al*, 2003).

### **Regulatory Response**

In response to the South Sea scandal when company shares fell 84% from their peak, government enhanced the power of the newly formed Bank of England, which changed the running of the country's finances (Paterson *et al*, 2003). In the USA, comparable state intervention has been pursued by both the Federal Trade Commission (FTC) and the Justice Department. On the issue of mergers, a more *laissez-faire* position has been adopted as was the case with Microsoft (Becker, 2001). However, even when regulations are introduced, executives find ways to circumvent them (Table 8). For example, in 1993, after considerable scrutiny of CEO pay, Congress changed the tax codes so that companies could not deduct executive salaries from their tax bill if they exceeded US\$1 million. This regulation did not reduce the growth of CEO pay but altered the structure of pay. Instead of high salaries, highly paid executives received increased grants of stock options. Because of accounting rules and practices these options never reduced reported profit but instead reduced taxes when the options were exercised (Table 9). For example, Cisco had received tax breaks sometimes exceeding its reported net income, whilst Microsoft received a US\$2.1 billion tax break as a result of exercised options (Henry *et al*, 2002).

**Table 8: Regulations and Results**

<b>Initiative</b>	<b>Regulation initiated by Congress</b>	<b>Results</b>
1989 Cap on 'golden parachute'	Excess tax on payments above 2.99 times of base salary	2.99 is the new minimum and company covers any excess tax for executives
1992 Disclosure of directors pay	Better disclosure of CEOs pay	Social comparison approach –how much other CEOs receive then try to get more
1993 Cap on tax rebate on executive pay	Salary over US\$1 million to be non-tax-exempt	Huge stock option grants and upping of most salaries to £1 million.

**Source:** compiled from Useem *et al*, (2003)

**Table 9: Tax Avoidance**

<b>Corporation</b>	<b>Pre-tax profit millions - 1996-2000*</b>	<b>Federal income tax million- 1996-2000**</b>
Enron	1785	-381 (rebate)
Colgate-Palmolive	1637	-21 (rebate)
Navistar	1368	28 (payed)

\* **Pre-tax USA profit is based on net domestic income. Adjustments have been made for items such as 'acquired in process research' and goodwill write-off in excess of the amount claimed for tax purpose.**

\*\* **Tax is currently tax paid, excluding deferrals on stock options**

**Source:** Institute on Taxation and Economic Policy, Citizen for Tax Justice (2003)

In 2001, approximately 58% of CEO pay of the larger American companies was provided for in share options (*The Economist*, 2002). However, options costs were typically not included in profit calculation when reporting to shareholders but included in preparation for tax. Although share-options are not the solo culprit of business scandals, their high profile has attracted government attention. In response to Enron, Global Crossing, World Com, Tyco, and other accounting scandals, the USA government has initiated a number of changes in accounting and taxation rules. In future, companies have to exercise options as a cost (i.e. outstanding shares) at the time they are granted. As the challenge of valuing options remains arbitrary, for example, through using any of three available Black-Scholes methods for options pricing, different results may emerge.

## **Stakeholder Influence**

The stakeholder perspective to corporate inter and intra-relations is concerned with the process of social engagement. The corporate relationship with society has a long history. For example, in the Middle Ages, 'God' was considered a stakeholder or a corporate partner whose profits could be distributed to the poor by the end of each year (Eberstadt, 1977). Even Smith's (1937) identification of external interests to the firm may be viewed as an early recognition of stakeholders. Barnard (1938) suggested that employees are an important factor in a firm's success and their interests need to be carefully assessed. Abrams (1951) identified four corporate claimants on the corporation - employees, stockholders, customers and the public, including government. It was Freeman (1984) who propounded Stakeholder Theory emphasising the role and influence of an array of actors on the firm. Freeman (1984: 46) defined a stakeholder as 'any group or individual who can affect or is affected by the achievement of an organisation's objectives', emphasising that organisations need to identify their direct and indirect stakeholders as well as their interests. Freeman (1984) defines the 'stake' that stakeholders have in the corporation as equity, economic or influence based and the power that they wield is exercised through voting. Irrespective of whether economic power or political power is adopted, influential stakeholders promote the notion of corporate obligation towards external social actors. Freeman (1984: 83) also suggested that firms need to know 'what they stand for', through a value analysis process, in order to look for congruency with stakeholders.

To date the adoption of stakeholder considerations in determining directors pay is limited to economic considerations within the bounds of stakeholder models of governance, (Kakabadse and Kakabadse, 2001; Kakabadse *et al*, 2001). However, within a globalising economic reality, stakeholder theory needs to be canvassed from a broader socio-political context in order to be sensitive to global stakeholders (Bebchuk *et al*, 2002). Social contract thinking that builds on legal concepts of reciprocal rights and duties between parties is necessary, but not sufficient. What is required is consideration of a much broader set of relationships than the ones between an organisation and society (Donaldson and Dunfee, 1994). Social contracts should also include the relationship between organisations and other societies and between societies. The emerging expectation for social responsibility through social reporting is an effort to aggregate various stakeholder information requirements and expectations. Social

reporting has its roots in the early 1940s. Interest was renewed in the 1970s as environmental accountability and, again, as social auditing in the 1990s, exemplified by certain Scandinavian and continental European firms moving towards more comprehensive corporate reporting thus culminating in the present day corporate social responsibility movement (Kakabadse and Kakabadse, 2003).

Wood (1991: 693) defines corporate social responsibility as a 'business organisation's configuration of principles of social responsibility, processes of social responsiveness and policies, programs and observable outcomes as they relate to the firm's social relationships'. In his view, corporate social responsibility starts with top management awareness of the need for corporate responsibility to stakeholder issues, which, in turn, leads to policy commitment and, ideally, ends with implementation at the operational level. Towards this end the Integrative Social Contracts Theory (ISCT) (Donaldson and Dunfee, 1994) provides for an understanding of stakeholder contracts at a macro-level. ISCT builds a bridge across a broad range of concepts of contract including the 'social contract' and business ethics. It explains that a social contract is one that builds on the legal concept of reciprocal rights and duties between parties but encompasses a much broader relationship between an organisation and society and how duties and rights involved in a social contract may be guided by both legal standards, such as corporate law and agency regulation, as well as by social norms about what duties are and should be owed by the parties involved to each other (Donaldson and Dunfee, 1994). Many economies are introducing legislation, which, in varying degrees, allows corporate boards to consider duties to stakeholders other than stockholders in the making of corporate decisions (Preston and Sapienza, 1990; Polonsky and Ryan, 1996). Thus, irrespective of the more cynical view that visible social involvement is simply a means of insuring business legitimacy (Preston and Post, 1975; Davis, 1973; 1975), the challenge remains of reconciling stakeholder demands, if for no other reason than the advantage to be gained from visible corporate responsiveness, and the creation of shareholder value, as two critical pillars that support the deterring of unwelcome stakeholder attention to senior executive remuneration.

### **Need For a Geo-Political Approach**

Relationships between an enterprise and its stakeholders are dynamic, complex, and ever changing (Ackerman, 1975; Mahon, 1989). Empirical research suggests that awareness of and responsiveness to

external stakeholders and external issues has positive effects on both corporate social performance and corporate economic performance (Miles, 1987; Clarkson, 1988; Frooman, 1997). Emerging evidence suggests that corporations that are pro-active and accommodating in the management of stakeholder relations perform better in terms of economic performance than those organisations that are reactive and defensive (Clarkson, 1988; Frooman, 1997).

Such complexity of relationships and interaction falls in the remit of political theories of organisation, whereby the firm is seen as a political coalition and executives as its primary political brokers (March and Simon, 1958; March, 1982). According to a political model, firm behaviour responds to the interests and beliefs of the dominant coalition. However, whilst organisations are ruled by political elites, or dominant coalitions, these elites do not last due to inter-elite conflicts that provide impetus for change (Selznick, 1957; Pareto, 1968: 176; Putman, 1976). These dynamics of political coalitions are central to understanding power in organisations and can help explain, for example, why succession is relatively independent from firm performance (Donaldson and Preston, 1995). For example, a political model of corporate governance can be perceived as an approach in which active investors seek to change corporate policy by developing voting support from dispersed shareholders, rather than by simply purchasing voting power and control (Pound, 1993). Shareholder activism, environmental lobby groups, changing economic conditions, changing markets, emergence of employee ownership of stock and the growth of global corporations all give rise to the geo-political model of corporate governance (Kakabadse *et al* 2001; Kakabadse and Kakabadse, 2001; 2003).

Changing socio-economic contexts and an increased rise in democratic politics that foster an open, decentralised process and full debate of alternative ideas will force corporations to maturely evolve in response to such developments (Pound, 1993). For example, an appreciation and understanding of the political marketplace is essential for the analysis of the role that the capital market mechanism plays in corporate governance (Gundfest, 1993; Turnbull, 1997). As Bhide (1994:138) argues, 'good governance requires real policy trade-off'. Hence, corporate governance performance issues are related to a broader political context and, as such, can be understood from the geo-political perspective (Bebchuk, *et al*, 2002).

With the emergence of Japan as a world economic power, more than the 90% of all firms listed on the Japanese stock market in 1988 had a scheme for employee stock option participation (ESOP) (Jones and Kato, 1993). Of the approximate 7,000 listed companies on the American stock exchange about 1,000 firms are at least 10% employee held (Tseo, 1996) and the trend in Russia, where employee ownership is higher than in the USA, (Blasi and Gasaway, 1993) raises the need for recognition of all stakeholders and the need for an extended strategic debate (Denham and Porter, 1995; Monks, 1996; Turnbull, 1997). However, ESOPs are no panacea. For a considerable number of firms, employee ownership has had little effect on participation and governance (Pendleton, 2001), and, in fact, in certain companies has put the investment capital of workers at considerable risk (Blasi, 1988). Employee participation in governance has had more positive impact through the introduction of employee directors and employee shareholder communities. The presence of an employee type of director encourages behaviour that is sensitive to the long term sustainability of the corporation (Covlin, 2003). For example, General Mills Inc, matches the bonuses awarded to senior executives with its pension contribution on behalf of its employees according to the year's performance in order to encourage long term thinking (Henry *et al*, 2002).

Whether unionised or not, the right of workers to elect representatives who meet periodically to review their company's HR policies, including executive compensation, training and development, pensions and other benefits, as well as layoff provisions, is advocated by 70% of the surveyed workforce in USA (Kochan, 2002). The value of making boards accessible to employee representatives is illustrated by TIAA-CREF practice, the largest educational pension fund covering college professors, whose example is being adopted by other organisation, such as airline companies (Kochan, 2002).

### **Broadening Understanding of Remuneration**

As relationships between firms and a broader range of stakeholders become more developed and commonplace, the nature of their communication needs to take the form of a genuine dialogue (Frederick, 1994). It has to go beyond one-way communication and current measures of non-financial performance, such as through Balanced Scorecard. Stakeholders will increasingly expect public

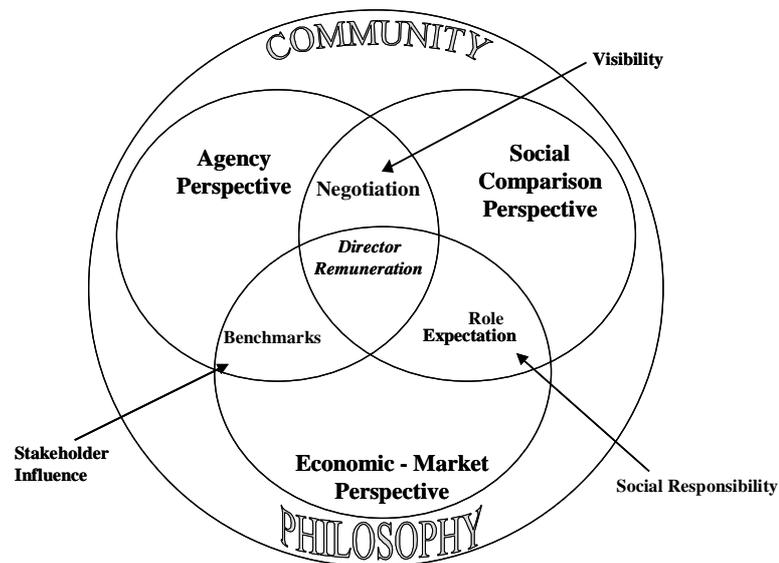
transparency of the business and those who fail to comply with such public expectations will risk public criticism and loss of reputation (Waddock and Graves, 1997).

In drafting a model of executive remuneration, incorporating broader stakeholder considerations, attention is given to agency, economic and socio-comparative theories that offer relevant insight as well as limitations in explaining director remuneration. Critical is the nature and relevance of incentives. The strength of belief in the efficacy of agency theory thinking, strongly suggests that appropriate incentives influencing senior managers performance need to be in place in order to induce improved company performance, (Kakabadse and Kakabadse, 2001). However, in order to account for broader stakeholder sentiment, these incentives need to be linked to broader socio-political factors that influence the environment in which the corporation and executives operate. These factors need to be inclusive of stakeholder relationships and corporate social and environmental responsibility issues. For senior executives to be more responsive to broader, globally located community issues, is particularly pertinent currently, as substantial changes are taking place in corporate and taxation rules and regulations as well as in other areas such as increased shareholder activism and the growing number of stakeholder driven not-for-profit organisations (NGOs) and campaigning organisations, such as the World Development Movement (WDM), and the International Confederation of Free Trade Unions (ICFTU). There is a growing need for further research to re-examine remuneration package instrument sensitivity to company performance against corporate social responsibility performance and corporate responsiveness to local and global communities. Inclusiveness (who is included in democratic dialogue), procedural propriety (the basis on which the dialogue is designed and implemented), responsiveness (sensitivity of various parties to dialogue), and outcomes (what happens and who bears the associated costs and benefits) are key indicators of corporate willingness to support responsible citizenship (Kakabadse and Kakabadse, 2003; Zadek, 2003).

Towards this end, a model of the components of director remuneration, accounting for geo-political influences, is presented (Fig. 2). The model allows for deliberative democratic processes, where all stakeholders can be involved in making collectively binding policy decisions. Policy proposals pursued on the basis of self-interest, are unlikely to survive the scrutiny increasingly gaining momentum in a globalising world. Encouraged are disclosure, bargaining and negotiation in the context of deliberative

policy making. In practice, this means that all critical and interested stakeholders should have the same chance to define issues, dispute evidence and shape the agenda of one's own work within a context of the governors accepting to govern and be governed. The need is to move from a corporate control philosophy, where employees can be treated as 'serfs' (Kakabadse and Kakabadse, 2001; Kakabadse *et al*; 2001) at the operational level, or as mercenaries owing no loyalty except to themselves and thus going to the highest bidder in the case of directors, to a philosophy of corporate citizenship, which, in turn, encourages development of a heightened awareness of the impact of business on society (Logan, 2000; Zadek, 2003). The irony is, that through inducing greater stakeholder awareness, the philosophy and practice of shareholder value may be more effectively promoted. Through providing greater customer value through human resource strategies that encourage higher levels of commitment, a positive stakeholder environment is generated in the firm, thus realising higher levels of shareholder value (McTaggart *et al*, 1994). Yet, there is still some way to go as, even today, with an ever growing stakeholder awareness and greater legal safeguards, one in twenty workers in USA companies who vote for the union can expect to be fired (Kochan, 2002). Terminology such as 'human resources', 'human capital', 'talent' or 'employees' implies ownership of people by other people. 'Corporate citizen' implies membership, loyalty and interdependency. The migration to a community philosophy to review corporate governance issues requires a re-definition of the role of the shareholder and the introduction of ideas of corporate constitutions and corporate citizenship. It is likely that the encouragement of citizenship will also 'bolster' current stakeholder remuneration practice, particularly concerning employee share option participation (ESOP) as a means to encourage active employee involvement in the affairs of the corporation, or more broadly, the environment (McTaggart *et al*, 1994).

**Figure 2: Geo-Politics of Director's Remuneration**



Source: compiled by authors

Considering that of the world's 100 largest economies, 50 are corporations (Handy, 1997) and that transnational corporations and large, nationally-based enterprises are rapidly filling the political vacuum previously occupied by nation states, the need for a geo-political perspective to better understanding all aspects of governance in corporations, including director remuneration, is increasingly pressing. Dealing with corporations as political institutions implies the need to apply the same rules as for a nation-state - democratic rights. Matters of human rights, free speech, the right to be informed, to a share of the proceeds of one's own work and that governors be socially and economically governed, are emerging corporate issues. The need for greater disclosure with regard to potential conflicts of interests, regarding corporate activities, client relationships, and other market sensitive news, as well as improvement in the quality, accuracy and relevance of financial information, are issues of equal critical importance. Enterprise has, after all, historically always been about a community of people.

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