

It's the economy – and CEO pay, stupid

By [Eleanor Bloxham](#)

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FORTUNE — The individuals who gathered in Davos, Switzerland last week are doing comparatively well in this economy. But many of the U.S. CEOs are concerned about the uncertain business climate. And many of their peers sit on cash while millions continue to search for work. Why are we in this current mess?



“Incentives may be driving CEOs to invest less,” says Columbia Business School professor John Donaldson and co-author of a [New York Fed staff report](#) exploring the connections between pay, business decisions, and the economy’s health. When CEOs are paid highly in options or restricted stock (as most U.S. large company CEOs are today), “the economy becomes more volatile,” he told me.

This kind of economic volatility isn’t driven by business fundamentals and makes the economy “unpredictable,” Pace Business School professor Natalia Gershun and a co-author of the paper told me last week. Unpredictability leads to uncertain times for everyone.

Decisions that harm companies and economies

Acting out of self-interest based on how they are paid, CEOs will fail to take actions in the best interests of their corporations, the paper’s authors argue.

Current symptoms of this sort of behavior include widespread cost cutting and a failure to invest in a company’s long-term future. CEOs can easily find themselves in a mode of cost cutting to boost their company’s stock price, which then becomes a self-fulfilling prophecy, Donaldson says. CEOs cut costs, the stock price rises, and so they keep cutting costs because it boosts the stock price over the short term.

Over time, this behavior will drive any business into the ground. In their defense, CEOs are merely acting out of rational self-interest. It’s the board’s job to align pay practices to avoid these unintended consequences.

Not all CEOs succumb to this shortsightedness, but with enough of them acting this way, the result is economic instability. CEOs will take actions that cause bubbles and slow recoveries. CEOs will tend not to invest idle cash when the economy needs them to (which is happening now) — and to hold too little capital when they shouldn't ("levering up" as we saw in financial firms in the run up to the crisis). Multiplied across the economy, "executive pay practices ... may have dramatic, adverse business cycle consequences," the paper explains.

The resulting economic volatility can affect a number of economic indicators, Gershun says. "GDP, employment, investment in productive assets and consumption" may all suffer from the way executives are paid today.

A wake-up call for boards, and the rest of us

While it may be difficult to admit that our best intentions can cause harm, corporate boards need to recognize that increased business risk and capital markets' volatility are not solely due to globalization, technological change, or governmental actions. Pay practices instituted by boards of directors have had unintended consequences, but changing those practices can make a difference. There is clear evidence that [countries](#) with cultures that do not use huge pay packages to motivate executives have [stronger economies](#), more financial certainty, and citizens who suffer from [less stress](#).

Boards are naturally inclined to pay their top executives much like their executive peers are paid. If you are a parent who has ever relented and bought your child that toy that "everyone else has," you understand. To restore balance and equilibrium, en masse, boards need to hire CEOs who are motivated by the job rather than the pay and undo outsize compensation programs tied to options and restricted stock. To support boards' efforts, every participant in the economy must support the kind of pay practices that will restore balance and stability for companies, the capital markets, and the economy as a whole.

Let's face it. We can continue to take no action, and jawbone at places like Davos about things we cannot fix. But the upshot of existing pay programs is that "CEOs may well find it in their self-interest to adopt investment policies that lead to ... [economic] instability," the paper concludes. "These results suggest that the early twenty-first century explosion in ... incentive compensation ... may have unforeseen consequences. We are only now beginning to see what these consequences are."

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