Institute for governance
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The Americanization of Canadian Executive Compensation[1]

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Executive compensation has become a nasty bone of contention in most developed societies. Whatever argument is invoked to explain and justify the large amounts paid to executives, the very public disparity of income within a given society and within the same organization turns the issue into, at best, a rallying cry for advocates of a saner society and, at worst, into an invitation to demagoguery.

The case against the level and form of executive compensation has been buttressed in the USA by the recent financial crisis when bonuses and incentive compensation are believed to have played a significant role. While Canada has managed to escape almost unscathed this crisis, the unease about executive compensation has continued to simmer; it has boiled over with the recent publication by the Canadian Center for Policy Alternatives of a sensational report on the 100 best paid CEOs in Canada.

We have been studying this issue for some time.

Reliable information on executive compensation in Canada only dates back to 1998; but for that period of twelve years, we have collected and arranged the compensation data to make them comparable to the U.S. data. *Our analysis covers the largest 60 companies by market capitalization for the whole period 1998-2010.* We believe that this group of companies compares well to the 500 largest American companies (by stock market value) making up the S&P 500[2].

The next figure shows the CEO *median*[3] compensation for these Canadian companies *in constant 2000 dollars* compared to the CEOs of the S&P 500 (but with no adjustment for Canadian/US $ exchange rate).

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[1] Drawn in part from ***A Capitalism of Owners***, by Yvan Allaire and Mihaela Firsirotu (IGOPP, December 2011) and ***Black Markets and Business Blues***, (FI Press, 2009)

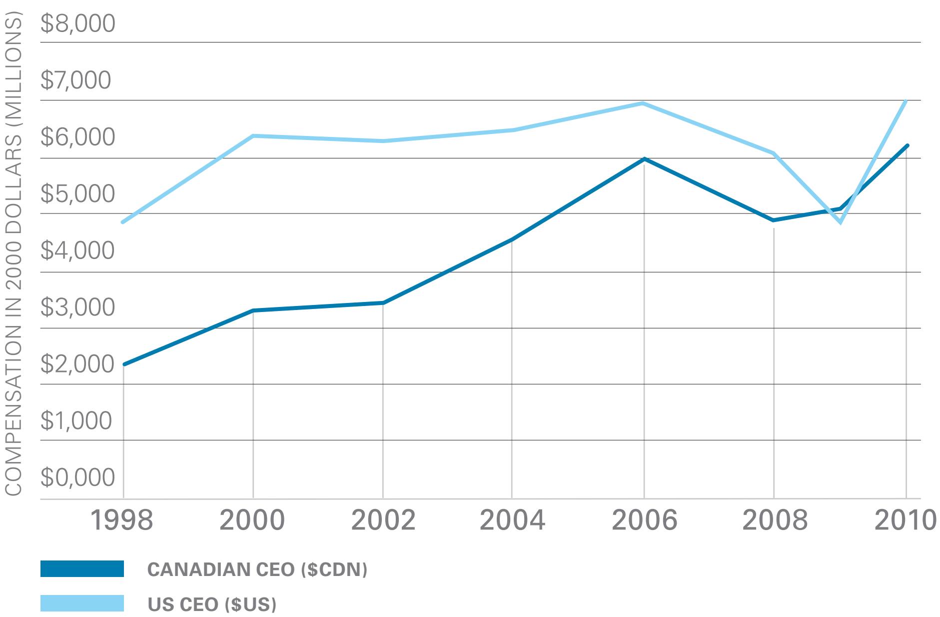
[2] Indeed, the smallest company of the S&P 500 had revenues of $1.4 billion and a market cap of $1.6 billion (December 31st 2010). The smallest of the 60 Canadian companies had revenues of $1.4 billion and a market cap of $3.4 billion (December 31st 2010). Of course, the Canadian group is more heavily loaded with mining, energy and financial service companies.

[3] The median is the compensation amount that it divides the group in two equal subgroups, those earning more than the median and those earning less than the median income; it is less influenced than the average by a few outliers.

Compensation of Canadian and US CEOs

Median Value in Constant 2000$

(COMPILED BY THE AUTHOR)



While the compensation of American CEOs levels of around 2000, the median compensation of Canadian CEOs keeps increasing until 2006. In 1998, U.S. CEOs earned more than twice what Canadian CEOs earned. By 2006, the compensation of Canadian CEOs has moved close to the compensation of U.S. CEOs. It has all but achieved parity by 2009-2010.

Could that be a result of the fact that an increasing number of larger Canadian companies include U.S. corporations among the "comparator" set of companies for the purpose of bench-marking and setting the compensation of their Canadian CEO?

The reasoning seems to be that Canadian senior managers are part of a North American market for talent and must be rewarded accordingly. Whether this argument holds water is unclear, certainly debatable; it may only be a useful fiction put forward by compensation consultants. But if that were so, then bringing moderation to Canadian executive compensation would depend on actions south of the border.

SOCIAL FAIRNESS?

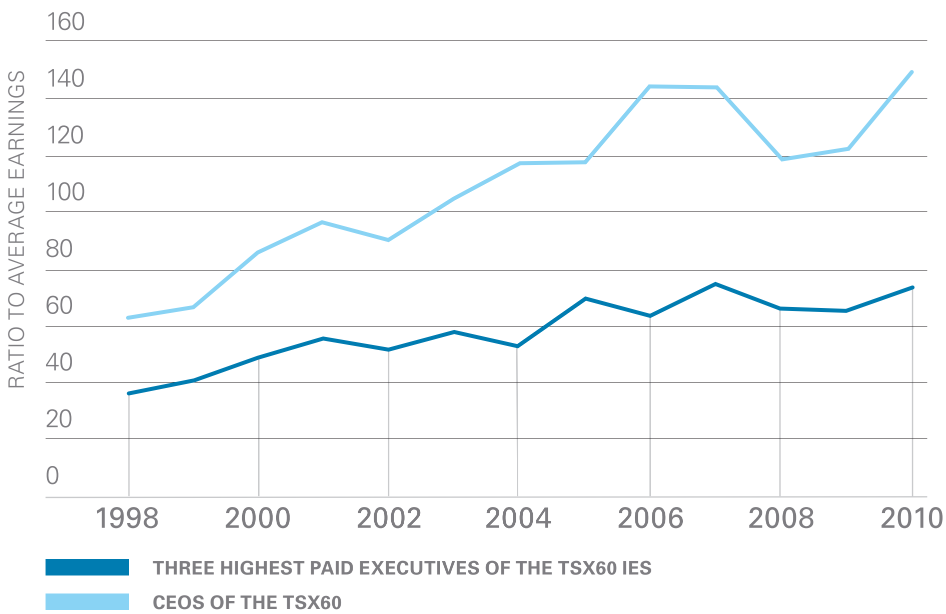
The issues of fairness and income inequality have important social and political reverberations; the marker most often used to pinpoint what's at stake is the relationship between executive compensation and the earnings of all other salaried members of society.

We believe that a fair assessment of this relationship should be based on median executive compensation, not the average, and should include the evolution of this ratio over several years.

The next figure provides such an assessment. It shows that the median compensation of Canadian CEOs, *which was about 80 times the average Canadian salary in 1998, has now reached a ratio of some 140 times.*

Ratio of Executive Compensation to Average Canadian Salaries 1998-2010

(COMPILED BY THE AUTHOR)



The ratio for the three best paid executives of the TSX 60 companies goes from below 40 to over 60 over the same period.

ALL IS RELATIVE!

Of course, CEOs are not prone to compare their compensation to that of the average worker. Corporate executives compare each other's compensation packages, helped in that exercise by solicitous compensation consultants. Then, executives may justly claim that their compensation is moderate, even paltry when compared to that of financial speculators and operators. Indeed, the most egregious compensation happens outside of listed companies.

The 25 best paid hedge fund managers earned in 2010 a total of U.S. $22.1 billion with $350 million the minimum earnings to get on this list. The collective pay-check of these 25 managers was *more than three times the total compensation of all CEOs of the S&P 500 companies*.

So, 25 guys (they're all guys), producing nothing tangible or really useful, managing a handful of people, speculating in ways that may be harmful to companies and countries, earned more than three times what the 500 CEOs of the largest American corporations earned… and these CEOs are greedy and overpaid! CEOs have a point, even if a moot one.

Two questions arise from these data:

- If the compensation of American CEOs is deemed excessive and in need of serious retooling, does that not carry over to Canada where executive compensation has all but reached the American level?

- What is a fair level of compensation for senior executives and what form should it take?

We have been studying this issue for some time. In our book published in 2009 ***Black Markets and***

Business Blues, we made several recommendations to curb the worst aspects of the typical executive compensation program:

- **Eliminate stock options as a form of compensation**

It may be difficult for companies to singly and swiftly eliminate stock options; regulations could do the trick but it is not advisable to bring the government into these matters; boards of directors could, and should, *reduce gradually the percentage of total compensation derived from stock options*. Great companies were built and innovative firms were created in the past without the crutch of stock options.

Furthermore:

- **Governments should eliminate all tax benefits (personal and corporate) which favor stock-related compensation.**

Depending on tax jurisdictions, the tax benefits granted to stock-related compensation are very generous and make this form of compensation irresistible.

- **The board of directors of a publicly listed corporation should adopt a policy about what is a fair and productive relationship between top management's total compensation and median earnings within the firm.**

Companies are unlikely to revert to the days when CEOs earned 25 times the average earning of their employees. However, the board of directors should set a ratio which is sensitive to the social, cultural and industrial circumstances within which the company operates.

It will be argued that unless all companies proceed hand in hand to implement these changes, those who do will lose key executives to those who don't. It is perhaps more accurate to state that companies might lose their most mercenary managers, but that is a benefit not a cost.

We must adopt policies and principles of management to bring back some level of trust and loyalty within and around companies, a long term perspective in their management and governance as well as due consideration of the stakeholders that give companies their legitimacy and purpose.

New public and private policies will be required to achieve this result.

We, at IGOPP, are carrying on an intensive evaluation of measures and policies to bring sanity and fairness to executive compensation.

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