

Issues in Executive Compensation

CRITICS OF EXECUTIVE compensation raise difficult questions: Why is executive pay so high? *Is* it too high? How can the executive compensation program be made more effective? How can trustees do a better job governing it?

To maintain support for tax exemption and publicly funded health programs such as Medicare and Medicaid, trustees and public relations staff of not-for-profit healthcare organizations need to be prepared to address these questions. Indeed, anyone who is regularly involved with executive compensation—CEOs, consultants, members of the board of directors' compensation committee, heads of human resources—has a responsibility to respond to these questions knowledgeably and thoughtfully.

Organizations approach decisions about executive compensation in their own ways, and the way an organization does so depends on its circumstances, what it can afford, and the values and beliefs that drive its decisions about executive pay. Trustees and CEOs make decisions they think are best for their organizations. We give trustees responsibility for governing executive compensation for precisely this reason—to make sure the decisions are made by wise community leaders who know the organization and its circumstances and values well, and who can be trusted to make informed decisions in the best interests of their organizations.

ARE EXECUTIVES PAID TOO MUCH?

The short answer is no. Executives are not overpaid. If they were, employers would not willingly pay them as much as they do. And when executives change jobs, their new employer would not pay them as much as or more than their previous employer did. There are exceptions, of course, due to special circumstances, but the question is whether executives as a class are overpaid.

But this short answer does not address the emotional intensity associated with the question, which arises from its moral, political, sociological, and economic dimensions. It is not one question, but at least four:

1. Are executives paid more than they should be paid?
2. Why should executives of organizations that are tax exempt and dependent on public funding for Medicare and Medicaid be paid as much as they are?
3. Why should executives be paid so much more than other employees?
4. Are executives paid more than they are worth?

People who are paid a lot less than executives—that is, most people—are likely to think executives are overpaid; they have a hard time imagining that a job or a person can be worth so much. The opinion usually comes with a moral veneer—no one *should* be paid that much. Sometimes the opinion is more explicit—it's wrong or immoral to pay a person so much.

Much of the deep-seated resentment of executive pay in the healthcare field can be attributed to the fact that tax-exempt hospitals are community institutions paid for in large part by taxpayers. It is colored by the opinion that we all have a right to healthcare services—so no one should get rich off them.

In the political sphere, the resentment takes the form of proposed limits on executive pay and other regulations. In some states, for example, no executive of a public hospital can be paid more than

the governor. In others, legislators propose limiting executive pay in hospitals to a multiple of average pay for other employees. The US Congress and state legislatures conduct hearings, launch investigations, and express outrage against hospitals for allegedly abusing the public trust. Since 1996, federal law and regulation have threatened to impose fines, or “intermediate sanctions,” on executives of tax-exempt hospitals and health systems if they are deemed overpaid, and on trustees if they agree to excessive executive pay.

High compensation for healthcare executives feeds social discontent over the widening disparity in wealth and income in the United States. It also drives boardroom debates about the extent to which executives should be well paid while the hospital is trimming costs everywhere else and asking employees to pay a greater share of the cost of healthcare and retirement benefits.

But labor market forces drive pay for executives, just as they do for other employees. Just as doctors are paid differently than nurses, because their jobs are different and represent a different segment of the labor market, executives are paid differently than doctors and nurses. Hospitals may be tax-exempt charities serving the public good, but they are still big, complicated businesses with narrow profit margins, and they need talented executives to keep them strong. Tax exemption and public funding for Medicare and Medicaid have no bearing on what it costs to recruit and retain executives. Each of the 6,000-plus hospitals in the United States needs a group of executives, creating a dynamic market for executive talent that determines how much executives are paid. There is no rational basis for the view that executives should not be paid as much as they are paid, just a personal attitude, generally held by someone who is paid less.

The intrinsic worth of an individual may be impossible to determine, but the intrinsic value of a job can be quantified. Economists and most workers judge the value of a job by how much it pays. A job is worth what an employer is willing to pay an employee to do it, or what an employee is willing to accept as payment for the job. Virtually no one doubts that principle—except when it comes to executive jobs.

Hospitals and health systems continually look for ways to reduce their costs. When they come across jobs that cost more than they are worth, they eliminate the jobs and either eliminate the work, redistribute it to other employees, or outsource it to cheaper labor. They view executive jobs the same way. When hospitals and health systems find an executive job that seems to cost more than it is worth, they eliminate it if they can and redistribute the work to other managers. The one action they cannot take is outsource the work to a cheaper labor force, because there is no cheaper labor force capable of doing the job well.

Therefore, executives must be worth what they are paid, because employers keep them on the job and willingly continue to pay whatever they are paid. Even when they leave or lose one well-paid job, they can usually find other employers who are willing to pay them just as much as or more than they were paid in their previous jobs.

WHY ARE EXECUTIVES PAID SO MUCH?

Common answers to this question are, “We have to pay that much or they wouldn’t work for us,” “We just pay the going rate, the same as everyone else,” or “That’s what it costs to hire someone to do the job.” Of course, if the question were that easy to answer, executive pay would not be criticized as often as it is.

But those answers are untrue. Most executives would not quit their job if they were paid a bit less—at least not until they accepted a better paying job. Many hospitals and health systems pay more than the going rate, and those that intentionally position pay above the median cannot claim that they only pay the going rate. Most organizations pay more than they would have to pay to hire someone to do the job; people who could perform the job reasonably well and who would be willing to do so for less than the person chosen are in ample supply.

The dynamics of decision making on executive pay differ from the dynamics of other purchasing decisions, and they often lead

organizations to pay more than they need to. Boards and CEOs do not let cost stand in the way when they are recruiting executives. They often decide whom they want to hire before they begin to discuss pay. They sometimes come around to admitting that they cannot afford to hire their first choice, but they just as often end up paying whatever it takes to get their first choice to take the job.

Most discussion of executive pay is based on the assumption that pay is set by labor market dynamics. This ignores the fact that most pay decisions affect what incumbents are paid, not what external recruits are paid. Employers voluntarily give executives raises every year. They voluntarily enhance benefits and perquisites from time to time and sometimes increase incentive opportunities for no compelling reason.

Three principal factors drive executive compensation to today's level:

1. The intent to hire the best talent available for the job
2. The intent to pay competitively enough to retain incumbents
3. The intent to pay above average in expectation of above-average performance

The intentions begin with the board's decision to hire exceptionally talented, highly experienced executives and continue with the board's willingness to pay the salary required to hire and retain them. External recruiting tends to drive pay up. When organizations recruit seasoned executives from other, similarly sized organizations, they generally need to pay well above average, more than they would need to pay to promote an internal candidate.

The intent to pay competitively drives up salary even for internally promoted executives and incumbents, however. Organizations whose policy is to pay at median increase pay faster than the rate of inflation for any executive paid less than median, and organizations whose policy is to pay at the 75th percentile continuously increase executives' pay to stay ahead of the pack.

The intent to pay above average in expectation of above-average performance drives up pay for all executives, whether or not they

are performing at an above-average level. Standard salary administration practices call for bringing salaries up to the intended level within a few years, as long as the incumbent performs reasonably well. Furthermore, incentive plans tend to reward institutional performance more than individual performance, so even average performers end up being paid above average.

The reasons executives are paid as much as they are have more to do with logic and belief than necessity:

- Organizations pay supervisors more than they pay their direct reports. They pay managers more than supervisors, department heads more than managers, executives more than department heads, and CEOs more than other executives. Organizations believe that higher-level jobs carry more responsibility than lower-level jobs do and therefore warrant higher pay.
- Following the same logic, bigger organizations tend to pay more than smaller organizations pay. Executives in bigger organizations have more responsibility than their counterparts in smaller organizations and therefore warrant more pay. Most US organizations follow this logic, as do most consultants who advise boards on executive compensation. The results of most executive compensation surveys reflect it as well.
- Hospitals are big organizations—bigger than most other organizations in small and midsize communities—so hospital executives have unusually big responsibilities. In many communities, hospitals are the biggest employer and often the biggest business, as measured by operating expenses. If only for that reason, one should expect hospitals to pay more than the smaller businesses in the same town do.
- Hospital executives' jobs are unusually complex and challenging due to the nature of a hospital's services, the risks entailed in making mistakes, the regulations governing healthcare, and the difficulty of collecting payment for the services provided. So healthcare organizations hire experienced people, who have

worked long enough in healthcare to know what needs to be done.

- Boards want highly qualified executives managing their hospitals to mitigate the risks involved in providing clinical care in a heavily regulated and litigious environment. They want to avoid relying on the less experienced executives they would be able to hire if they were to pay less.
- Boards believe they need to pay at median—the 50th percentile—or above to attract high-quality executives, so they intentionally position salary ranges at or above median and offer competitive levels of incentive opportunity and benefits. Almost every organization adopts such a policy and commits to paying more for executive talent than half of its peers—those paying below the 50th percentile—and trying to remain reasonably competitive with those that pay above the median.
- Boards want to maintain good morale on the executive team. They believe they can do so by paying the CEO well, making sure that she is satisfied with her pay, and generally acceding to her requests for raises and bonuses for other executives.

In their book *Pay Without Performance: The Unfulfilled Promise of Executive Compensation*, Bebchuk and Fried (2004, ix) claim that a structural flaw in governance—an imbalance in power—gives CEOs too much influence over their own pay and impedes the effective governance of executive pay. “The absence of effective arm’s-length [bargaining with executives over compensation]—not temporary mistakes or lapses of judgment—has been the primary source of problematic compensation arrangements.”

While apologists for executive pay have attempted to discredit Bebchuk and Fried’s argument (see, e.g., Kay and Van Putten 2007), anyone who has experienced compensation committee meetings appreciates the predicament Bebchuk and Fried’s argument represents. Directors are expected to make decisions in the

best interests of the corporation, the shareholders, or, in the case of a local not-for-profit organization, the community. When determining executive compensation, however, they often seem to put executives' interests ahead of those of the organization, unless the best interests of the organization are to maintain harmony in the boardroom and morale in the executive suite. Why else would directors agree to pay bonuses to cover executives' tax obligations on benefits and perquisites, eliminate or relax vesting requirements on supplemental retirement benefits, lend the hospital's money to executives to finance deferred compensation in a split-dollar insurance scheme, or adopt countless other approaches to delaying or minimizing tax obligations on deferred compensation?

As long as they are pleased with performance, directors tend to be more generous with CEOs' compensation than CEOs are with the pay of their direct reports. Many committees tend to approve whatever pay or benefits the CEO recommends for other executives because they are accustomed to following the CEO's leads in most areas and regard decisions on pay for other executives as management's turf, not the board's. Directors often regard the CEO as a peer (the CEO is usually a director, too, and due to technical competence, the real leader of the board in most areas), so committees often find it difficult to maintain an arms'-length relationship with the CEO in governing executive compensation.

Executives are paid as much as they are paid because they are in great demand. Hospitals all want to recruit and retain outstanding leaders, and they are willing to pay well to get them and keep them.

DO CONSULTANTS DRIVE UP EXECUTIVE PAY?

Consultants are not responsible for the continuing escalation in executive pay—at least not in tax-exempt healthcare organizations, and at least not now—since boards began to exert more control over executive compensation five to ten years ago. Consultants generally strive to avoid any action that inflates market values or promotes

inflation in executive pay. They work for the compensation committee, not for management, and they have an obligation to be as objective as possible in providing data and advice to committees. Nonetheless, the continuing escalation in executive pay is often attributed to consultants.

The reason is that they provide the data that committees use in determining salary increases. Because market values rise every year, analyses invariably show that salaries established the year before are now less competitive than they were when they were set.

But it is the compensation committee, not the consultant, that wants to keep pay competitive. The board has set a policy of positioning pay at median or above, and the committee's role is partly to keep pay at the intended level. The compensation committee asks, "What will it take to keep salaries competitive?" If salaries are already competitive, the consultant replies, "You will need to increase salaries by 3 percent to keep up with the market."

In years past, boards allowed CEOs to choose their own consultants, and consultants knew that the way to maintain the relationship was to keep the CEO satisfied with the results of their work. While consultants understood that their real client was the corporation, the nature of the relationship with the CEO sometimes trumped their adherence to professional standards.

Over the past decade, however, boards and their compensation committees have reclaimed control of the consultant relationship. They now issue requests for proposal periodically and sometimes intentionally change consulting firms every few years to keep consultants from developing a close relationship with management. Many committees now routinely ask their consultants to declare their loyalty to the committee.

Consultants have generally encouraged this change by promoting best practices in governing executive compensation. Most consultants have come to understand that they must demonstrate their objectivity and independence to the committee and guard against being manipulated by management.

Most of a consultant's work is straightforward and technical—collecting and analyzing market data, comparing the client's pay to market data, summarizing the analysis, drawing the obvious conclusions, and offering the obvious recommendations. A typical report amounts to little more than a lot of tables and charts, some observations dressed up as conclusions (e.g., salaries for your executives are, on average, 3 percent below median), and some perfunctory recommendations (e.g., to maintain that market position, you should increase salaries about 3 percent).

Consultants exercise judgment throughout the process, however, in ways that affect their conclusions. They generally know that certain segments of the healthcare industry pay better than others, and that pay levels are higher between Boston and Washington, D.C., and between San Francisco and Los Angeles than elsewhere in the country. They know that large organizations pay more than small ones do, that private institutions generally pay more than public ones do, and that urban hospitals pay more than rural ones do. They know that the more organizations they include in a peer group from a high-paying segment, the less competitive a client will look. Consultants sometimes define peer groups in ways that increase prevailing pay or benefit levels—but so do boards, and it is ultimately the board's responsibility to determine the appropriateness of the peer group.

Admittedly, several techniques that consultants use in gathering data tend to reinforce inflation in executive pay levels or even drive it up inappropriately. One technique assumes that hospitals and systems will continue to increase salaries the next year, as they have in the past, and builds an anticipated inflation factor into estimates of market value. Another compares an organization's size in the current year or the next year with other organizations' size in the past year. (Survey data are always retrospective, so participants' revenues or expenses are almost always last year's dimensions.) The technique with the greatest impact on pay levels, though, is using revenues or expenses, rather than a volume or activity metric, as the measure of organizational size, as charges and costs per unit of service tend to rise a bit every year.

Most economists, financial analysts, and consultants consider revenues and operating expenses good measures of the size of an organization or the scope of an executive position. In the health-care industry, however, the rate of inflation in costs and revenues raises questions about its appropriateness for that purpose. Trustees ask why a 10 percent increase in revenue or a 6 percent increase in operating costs should affect the value of executive jobs when the number of staffed beds, adjusted admissions, and employees has not increased. Why, in other words, should their success in getting better rates from payers mean they should pay their executives more?

Healthcare delivery is far more efficient today than it has been in the past, despite the inflation in costs. Much of the inflation results from the use of increasingly sophisticated equipment and supplies, more intensive interventions, better pharmaceuticals, and sicker patients. The notion that executive jobs in a hospital are worth no more today, on an inflation-adjusted basis, than they were ten years ago is likely wrong, because it assumes that the intensity level per patient is the same as it was ten years ago. Operating expenses may be as good and as appropriate a measure of relative size as we can find, given how weak the alternatives (staffed beds, adjusted admissions, full-time-equivalent employees) are.

On the other hand, two commonly used consulting techniques have the countervailing effect of reducing market value estimates. One uses bonuses or incentive awards earned last year and based on last year's lower salaries in calculating total compensation and in determining whether this year's total compensation opportunity is competitive. Another technique uses market values at the beginning of the year to set next year's salaries. The new salaries may be appropriately competitive on the day they are set but will gradually fall behind the market by the rate of inflation in salaries over the coming year. In the end, consultants have little influence on inflation in executive pay because—in tax-exempt hospitals and health systems, at least—inflation is no higher in executive pay than in pay for other employees.

DO COMPENSATION SURVEYS DRIVE INFLATION IN EXECUTIVE PAY?

Surveys, too, are often blamed for driving inflation in executive pay. But surveys merely convey information. The most important information a new survey conveys is how much salaries have increased over the past year and what the market values are this year, as opposed to what they were last year. The survey information itself has no effect on pay. It is trustees' and executives' commitment to keeping pay competitive, using the information that surveys convey, that drives inflation in executive pay.

Compensation surveys do a good job of showing the range of market pay practices, from the 25th to the 75th percentiles and sometimes from the 10th to the 90th percentiles. The range of market values for a job is so broad that even a salary at the 25th or 40th percentile is competitive, albeit not competitive with the top half of the market. But compensation committees rarely pay attention to the 25th or 40th percentile data. They only want to look at values at or above median. They are not looking for bargains or excuses to hold pay levels down. They are looking for reasons to move ahead with the anticipated regular annual salary increases most large employers deliver every year in the unending effort to keep pay competitive.

DOES EMPIRE BUILDING INCREASE EXECUTIVE PAY?

Some trustees, after watching their organizations expand and seeing the effect that growth has on executive pay, wonder whether executives try to increase the size of their organizations in a gambit to increase their pay. The growth of hospitals and health systems over the past few decades has increased prevailing pay levels for healthcare executives, providing the evidence critics need to make their argument that empire building is partly driven by its effect on executive pay.

Thirty years ago, most hospitals were independent; now, most belong to multihospital systems. In addition, hospitals are generally bigger and more complex than at any time in the past. Many small hospitals have closed and whatever volume they would have had has now been distributed to the hospitals that remain open; some hospitals have merged with others and consolidated their business; and the population is aging, driving hospitals to add capacity, after two decades of reducing capacity in the 1980s and 1990s. Even those hospitals that have not added beds have grown by adding outpatient services and increasing throughput—handling more admissions by shortening length of stay.

The impetus toward growth is less often empire building or executives' desire to increase their pay than a need to respond to external pressures to improve competitive position or economies of scale. Besides, the desire for growth comes as much from trustees as from executives. Trustees who are business executives believe that growth is essential for the health of a business. Businesses are either growing or waning, they believe, and only growing businesses can afford to invest in new programs that will position them for success in the future. By leading this effort to grow, executives have been acting exactly as they have been asked to act by their boards and by society as a whole. Now that they are leading bigger, more complex organizations, their jobs are more difficult, carry more responsibility, and seem to warrant more pay.

Yes, empire building may increase executive pay, but the increase is the result of growth and consolidation in the industry—not a deliberate ploy to increase executive pay.

HOW MUCH OF EXECUTIVE PAY IS RELATED TO PERFORMANCE?

Boards and executives defend executive compensation by pointing out how much of it is based on performance. The reality is that only a small portion of total compensation for executives of

tax-exempt hospitals and health systems is tied to performance—except that executives cannot hold onto their jobs long if they do not perform well.

When we talk about pay for performance, we generally mean pay as a reward for current performance, or pay at risk in relation to current performance, not pay as the cumulative result of past performance. In other words, pay for performance essentially means incentive. Incentive compensation is typically about 30 percent of salary for CEOs of independent hospitals and systems and about 15 to 20 percent of salary for vice presidents. It amounts to only 20 percent of total compensation for CEOs and 10 percent to 14 percent of total compensation for most other executives. While not trivial, incentive compensation is not a significant portion of pay, and performance is not a major determinant of executive pay in not-for-profit healthcare organizations.

Furthermore, the portion attributable to incentive compensation is not highly variable—certainly not as variable in healthcare as in other industries. Incentive plans in not-for-profit healthcare organizations are generally designed to moderate the degree of variability in pay. Maximum opportunity is typically only half again as much as the target or expected value. Most incentive compensation plans are not structured as profit sharing, in which the size of a pool reserved for incentive awards varies directly with profits (the most variable and volatile measure of performance in any industry). Instead, most plans use balanced scorecards as their framework, whereby the size of awards is tied to five or more measures of performance. Several measures frequently used, such as patient satisfaction scores, are notably less variable than financial performance metrics. More important, tying awards to multiple performance measures makes awards less variable, as good performance on one measure offsets weaker performance on another.

Most organizations with executive incentive plans pay awards almost every year. Surveys show that in any given year, 80 percent or more of them pay awards, and those that pay awards only once in a rare while are counterbalanced by those that rarely miss pay-

ing awards. The consistency of incentive payouts from year to year is a function of the stability seen in volume of activity, operating expenses, reimbursement, patient satisfaction, and clinical quality. This stability is upset only when a serious disruption occurs, such as a strike, a recession, or a defection of a group of specialists.

HOW MUCH PAY SHOULD BE TIED TO PERFORMANCE?

Many trustees would like to see more pay tied to performance. Trustees who favor increasing the amount of pay at risk believe that incentive compensation promotes good performance and assume that increasing the amount of pay at risk will optimize performance. They are generally comfortable with increasing pay at risk because they are accustomed to seeing more pay at risk in their own companies than in the hospitals or health systems they govern. Sometimes they propose increasing pay at risk as an alternative to increasing salaries each year.

Most executives—healthcare and non-healthcare alike—do not favor putting more of their pay at risk, unless it is additional pay. Executives generally reject the idea that they perform better because of incentive compensation, as it implies they would perform poorly without it. They generally admit that they are intrinsically motivated and will perform well whether or not their pay reflects their performance. This does not mean they do not like incentive plans or want to abandon them, just that they view bonuses as appropriate reward and recognition for a job well done, rather than an incentive to perform better than they would otherwise. It also does not mean that they do not want more incentive opportunity—only that they do not want to put any part of their salary at risk.

In addition, they recognize that incentive plans are risky, and that putting too much pay at risk, or putting too much emphasis on one or two measures of performance, could have unfortunate unintended consequences—just as incentive opportunity in financial services can promote excessive risk taking.

Incentive plans engender an unnecessary level of friction and skepticism between trustees and management: Trustees think management sets goals too low and management thinks trustees set goals too high. Increasing the amount of pay at risk, executives suspect, would only increase the friction and skepticism.

Trustees who do not favor increasing the amount of pay at risk recognize that incentive compensation places a burden on them, too. Their approval of such plans means that when the large awards are paid, they must justify them to the public, medical staff, employees, or legislature and explain why total compensation varies dramatically from year to year. They recognize the difficulty in setting appropriate goals and dealing with externalities—events outside the control of management—and the effects of board-approved changes in plans and priorities. Increasing the amount of pay at risk only magnifies the challenges trustees face related to incentive compensation plans.

The utility of incentive compensation is in promoting discipline in planning and goal setting and in focusing attention on a few goals that are more important than the others. Putting no pay at risk, or too little, minimizes the need for management and the board to agree on plans and goals. Placing too much pay at risk raises the stakes to the point that negotiating skills and game-playing strategies can distort planning and goal setting.

The right amount of pay at risk is probably whatever it takes to fill the gap between salary and total cash compensation at the levels specified in the board's compensation philosophy. It is relatively modest if the compensation philosophy calls for positioning both salary and total cash compensation at median (or both at the 60th or 75th percentile). It is significantly more if the compensation philosophy calls for positioning salary at median and total cash compensation at the 65th or 75th percentile. Incentive opportunity is generally modest at tax-exempt healthcare organizations for a good reason—boards and executives have learned through experience how difficult it is to manage pay-at-risk programs.

WHY PAY RETENTION INCENTIVES WHEN EXECUTIVES ARE ALREADY PAID COMPETITIVELY?

Sometimes hospitals and health systems offer executives retention incentives—incentives to stay with the organization for a specified period. This type of incentive amounts to extra pay for staying—nothing else—on top of fully competitive pay for working and performing well.

The purpose of a retention incentive is to ensure management continuity and organizational stability by discouraging turnover at critical times. Occasionally a retention incentive is used in lieu of a signing bonus, a long-term incentive plan, or a supplemental retirement benefit.

The most common uses for retention incentives are to

- retain executives as long as they are needed during a merger and post-merger integration period;
- retain executives when the organization is facing a massive restructuring;
- retain candidates for the CEO position in the years directly preceding the current CEO's retirement;
- retain the leader of a large, expensive project until it is completed;
- persuade an executive to stay after her retirement benefit is fully vested; and
- retain a young, high-profile executive who is looking for promotion opportunity.

Board members generally do not favor retention incentives because they are not contingent on performance. Trustees rarely agree to introduce such incentives unless the board is concerned about losing executives at a time when the organization needs stable leadership or wants the CEO to stay longer than she otherwise might.

Retention incentives work. They are usually effective at retaining executives for a year or two, as long as the plans are rich enough to outweigh any salary increase and hiring bonus another employer might offer.

They may also be unnecessary, as the executives might stay anyway. But waiting until the risk becomes a catastrophe is not a smart approach, as by that time no action can be taken to mitigate the situation. For example, losing an information technology executive in the middle of a \$50 million electronic health record implementation project can be a disaster; a retention incentive is a plan for avoiding that disaster. Even situations that may not end in disaster can benefit from having a retention incentive in place. Losing a strong internal candidate to succeed the current CEO, for example, may not be catastrophic, but it imposes risks that the organization might need to get along with no CEO for a while and that it might not be able to find an equally qualified candidate outside the organization.

Retention incentives are problematic, however, because they usually result in overpaying participants for a time. But because retention incentives typically last for only a year or two (no longer than five), the problem is short lived.

Once they have been paid, though, they become problematic in another way, as compensation drops by the value of the retention incentive. Executives may feel underpaid, and boards may encounter pressure to raise salaries, renew the retention incentive, or replace it with a permanent incentive plan.

WHY PAY SPECIAL BONUSES FOR COMPLETING ACQUISITIONS OR PROJECTS WHEN EXECUTIVES ARE ALREADY PAID COMPETITIVELY?

After completion of an acquisition or a major project, organizations may pay a special bonus to the executives who led the effort.

The special bonus serves to thank the executives for the extra work they did to ensure the project's success.

The rationale for paying the special bonus is that no part of the executive compensation program is intended to compensate executives for the extra work involved in the acquisition or special project; in other words, it was additional uncompensated work, not part of the jobs they were paid to do. That rationale presumes, of course, that executives' roles are defined in terms of keeping operations running smoothly, rather than improving operations, finding and making the most of opportunities to strengthen the organization, and leading change. That presumption is wrong, of course—competitive compensation already encompasses pay for these efforts.

The underlying premise of special bonuses is that the executives who led the acquisition or special project added value to the organization, and some of that value should be shared with them. This concept is borrowed from the for-profit sector, where such rewards are fairly common and executive pay programs are designed to share with executives any wealth they create for shareholders.

However, this premise is antithetical to the idea that tax-exempt charities are operated solely for the benefit of society and that no part of their earnings inure to the benefit of private individuals. Sharing with insiders a portion of the value gained from an acquisition could be considered private inurement unless the bonus paid is clearly appropriate for the work done, the work done was not already paid for in some other fashion, total compensation including the bonus is reasonable, and the bonus does not amount to a distribution of charitable assets. An especially damning aspect of special bonuses is that the organization has no obligation to pay them, unlike awards under a formal incentive plan. The deal is done, the project complete; only at this point does the CEO or a trustee suggest giving something away that belongs to the organization.

If the award were structured as a retention incentive tied to completion of the project, or if it were built into a formal annual

or long-term incentive plan, the contractual structure would create an obligation to pay and render it a non-gift. The fact that such a bonus is discretionary and retrospective, especially if it is large, and especially if the executives are already well paid, makes it risky, so special bonuses of this type should be used with caution.

WHAT IS THE APPROPRIATE RELATIONSHIP BETWEEN PAY FOR EXECUTIVES AND PAY FOR OTHER EMPLOYEES?

This question is one of social justice, made more compelling by the widening income gap between hourly workers and senior executives. CEO pay has risen to 400 times that of the average worker in big publicly traded firms (Institute for Policy Studies and United for a Fair Economy 2008).¹ In response, people² have proposed limiting CEO pay to no more than 20 times the pay of the average worker, citing the much tighter gap in Japan between CEO pay and the pay of the average worker.

Before embracing this populist idea, one ought to consider some of its obvious implications. Organizations that employ many highly skilled technical professionals (e.g., hospitals, software firms, law firms, medical practices) would pay their CEOs far more than would organizations of the same size that rely on many low-skilled, low-wage workers (e.g., retailers, hotels, fast food restaurant companies, firms that outsource most of their work to low-wage foreign countries). Ironically, the firms with higher-paid labor deliver far more of their added value through the intellectual capacity of their workers than the firms with lower-paid labor do, while the firms with lower-paid labor deliver most of their added value through the intellectual capacity of their management team. Using the same ratio across different types of firms seems to deliver the wrong result.

It would mean that CEO pay would be no more in a big firm than in a small firm, if the average workers' pay were the same. Of course, the value of the CEO position is worth more in an orga-

nization with 10,000 employees than in an organization with 100 employees, so capping CEO pay to a specific multiple of average worker pay makes little sense. Any appropriate formula would define CEO pay as a factor of organizational size as well as average employee pay.

Most large organizations do have a formula of sorts that ties executive pay to pay for other employees; it is the compensation philosophy. Through that philosophy, the organizations aim for a degree of consistency. If they pay the workforce as a whole at median, for example, they generally pay executives at median, too.

Even better at promoting consistency between executive pay and pay for other employees is a job evaluation system. As long as an organization uses the same compensation philosophy for executives as it uses for other employees and sets pay ranges based on job evaluation points, salary ranges for executive positions will be directly proportional to the scope of job responsibilities.

Some commentators, aiming to move the debate out of political and ethical domains, have tried to redefine it in terms of the relationship between the CEO's pay and pay for other senior executives. That gap, too, may be higher than it should be, but it misses the point of the debate, which is why executive pay keeps rising when pay for the workforce as a whole is flat; why executives should keep their supplemental benefits as companies cut benefits for the workforce as a whole; and why pay for executives of American firms should keep rising even as they eliminate well-paid jobs for American workers by outsourcing work to Mexico, India, or China.

HOW SHOULD WE BALANCE CONCERN FOR PAYING EXECUTIVES COMPETITIVELY WITH OUR NEED TO TRIM COSTS?

For at least the past 30 years, hospitals have been under relentless pressure to reduce operating costs and become more efficient.

Until recently, they have generally not looked at ways to reduce executive compensation, other than by eliminating unnecessary executive positions. While they have looked at every other opportunity to reduce expenses without harming quality, service, or operational effectiveness, they have overlooked opportunities in executive compensation—for fear of alienating executives or losing them to competitors, yes, but mostly because they believe that any cuts would leave their compensation programs less than competitive.

Boards have been perhaps too concerned with making sure executive compensation is competitive. They should instead focus on paying enough compensation to recruit and retain the leadership talent the organization needs to be successful now and in the future. Trustees should consider using voluntary turnover as the test of whether executive compensation is high enough, or too high—but only turnover explicitly linked to accepting higher-paying jobs elsewhere, and only those where the incremental pay is from a lateral move rather than a significant promotion. Too little voluntary turnover is a good indication that pay is higher than necessary, just as too much voluntary turnover is an indication that pay is too low.

Hospitals and health systems should look for ways to trim the cost of executive compensation, just as they look at ways to trim payroll costs for the workforce as a whole. Because they will be increasingly challenged by scarcity of resources in the future, they will need to look at executive compensation as an expense that needs to be managed carefully—more, perhaps, as a matter of being even-handed and thorough than in expectation of reducing costs much.

WHY SHOULD WE GIVE BETTER BENEFITS AND PERQUISITES TO EXECUTIVES THAN TO OTHER EMPLOYEES?

Many hospitals and health systems give better benefits and perquisites to executives than to other employees, presumably because

trustees were once told—often by vendors who wanted to sell them insurance—that they needed to give executives generous benefits and perquisites to ensure that their compensation programs were fully competitive.

Some hospitals and health systems, by contrast, give executives less robust benefits than they give other employees, as a result of caps and limits on standard benefits set by regulators and insurance carriers. Capping benefits at incomes of \$50,000 or \$100,000 or even \$250,000 disadvantages executives because the ceiling is too low to allow the promised benefit to cover their full income. A benefit, for example, that promises employees life insurance of two times salary up to a maximum benefit of \$100,000 is unfair to employees making more than \$50,000 a year. One that promises employees income continuation in the event of a long-term disability of 60 percent of salary up to a maximum benefit of \$5,000 per month is unfair to employees with salaries higher than \$100,000 a year. Legislative caps on the amount of income that can be counted in determining qualified retirement benefits also intentionally disadvantage higher-paid employees.

It is easy to argue that employers should try to close that gap and cover as much of executives' income as they can at a reasonable cost, to fulfill the implicit promise made to employees in the formula for the basic benefit. It is harder to justify giving executives richer benefits than hospitals give their other employees.³ Why, for example, should they give executives life insurance of three times salary if they give employees only one times salary? The usual rationale is to meet competitive standards, but that is not a compelling rationale when resources are scarce and hospitals have cut expenses wherever else they can.

Many hospitals and health systems still provide defined-benefit or target-benefit supplemental retirement plans to executives after having eliminated pension plans for other employees on the premise that they are too expensive, and having substituted significantly less generous defined-contribution plans. What is particularly difficult to justify is that hospitals and systems were enriching

retirement benefits for executives over the last two decades at the same time they were cutting retirement benefits for other employees.

On the other hand, a strong case can be made for giving executives more vacation time and a larger severance package than are given to other employees. It is difficult to recruit seasoned executives without special executive vacation and severance schedules. Vacation and severance generally start at a low level for new employees and increase with tenure; by moving to a new employer, however, newly recruited executives are giving up whatever tenure they had built up in their last job. Giving executives an enhanced vacation schedule does not cost much because they are not replaced while they are away. Enhanced severance costs more, of course, but the premise of severance is to provide income continuity for the period of time an employee terminated without cause will need to find another job; it takes far longer for executives than for nurses to find their next job after having been laid off. Without offering enhanced severance, though, hospitals would have a hard time recruiting new executives who need to uproot their families and move across country to accept a new position.

By their nature, benefits are paternalistic substitutes for additional compensation. Employers have fallen into the pattern of buying insurance for employees to cover healthcare costs and provide disability and death benefits on the assumption that employees will not buy adequate protection on their own. They provide retirement benefits (in lieu of higher wages) on the assumption that even if they were paid more and given the choice between saving or spending, employees would not generally save enough money to accumulate an adequate retirement nest egg.

But basic benefit packages for the workforce as currently designed encourage employees to take at least partial responsibility for the cost of benefits by making participation in insured benefits voluntary, giving them incentives to forgo health insurance altogether or to choose less expensive high-deductible plans, requiring them to pay a portion of the premiums for insured benefits, or providing

all or a portion of the retirement benefit as matched contributions payable only if the employee contributes to the plan.

By contrast, supplemental benefits for executives are usually paid in full by employers. Trustees should consider requiring executives to take on a meaningful level of responsibility for these benefits, as other employees are expected to do. Executives, after all, are in a better position than other employees to make wise choices between cash and benefits; if they are not willing to pay a portion of the premium for supplemental life or disability insurance, or if they would rather take additional cash instead, it is probably not wise for the hospital to pay the entire cost of these benefits. Likewise, if matched savings plans are the best approach to providing retirement benefits to other employees, would they not also be good for executives?

The gradual disappearance of most visible perquisites and certain supplemental benefits for hospital CEOs, such as permanent life insurance and medical expense reimbursement policies, shows that they are not a competitive necessity. Other perquisites and benefits may not be competitive necessities, either.

ISN'T THERE A WAY TO GET EXECUTIVE PAY UNDER CONTROL?

Executive pay is under control. Saying that it is out of control implies that it increases of its own momentum. Executives are paid what trustees want to pay them and in the ways trustees want to pay them. At least they are paid what trustees have agreed to pay them, in ways that trustees have approved at some point in the past, and in ways that trustees continue to authorize.

Executive compensation is controlled by the board's compensation policy and by the actions of the compensation committee. Annual salary increases are typically modest, executive benefits are generally reasonable, and incentive plans reward executives only when and to the extent that their performance meets the board's expectations.

Critics who say executive pay is out of control mean that it is too high. What they want to see is pay for executives lowered, and lowered a lot. They may want regulations to limit executive pay, but regulations have not worked in the past and are not likely to work better in the future.

Trustees are not likely to cut pay significantly, at least not enough to satisfy anyone who thinks that executive pay is out of control, and legislators are not likely to limit pay in any meaningful way. There are a few things trustees could do, however, to feel that they are moderating executive pay a bit. They could stop pay from rising faster for executives than for other employees, and they could stop giving executives richer benefits and perquisites than they give other employees. For these measures to be implemented, however, boards would need to change the way they think about executive compensation and adopt some of these best practices:

- Stop placing so much emphasis on paying competitively.
- Stop doing things just because other organizations do them.
- Pay executives as much as necessary to recruit and retain them, but not more. Use the organization's recruitment and retention experience as the litmus test in determining whether pay is competitive.
- Recognize that you cannot pay enough to hold onto an executive whose ambition drives him to look for the next good opportunity for career advancement.
- Avoid customizing benefits, perquisites, or contractual terms for individual executives—even the CEO.
- Address questions about the structure and value of executive compensation with the same rigor used in zero-based budgeting and in making decisions about investments in other programs. In other words, look at resources devoted to executive compensation as resources that cannot be used for anything else.
- Begin and end committee meetings in executive session to give members the opportunity to raise concerns and identify

issues that need discussion without worrying about friction with management.

- Report the compensation committee's decisions to the board in detail. Aim for transparency. If you are not comfortable reporting a decision to the board, it is probably the wrong decision.

NOTES

1. In *CEO Pay and the Great Recession*, the seventeenth annual executive compensation survey, the Institute for Policy Studies (2010) reports that CEO pay declined in 2009 to 263 times average worker pay. In "CEOs Distance Themselves from the Average Worker," the Economic Policy Institute reports that the multiple fell to 185 in 2010, then rose to 243 in 2011 (Bivens 2011). The Heritage Institute (2007) shows an exhibit reporting the multiple as 531 in 2000. Regardless of the year-to-year fluctuation in the multiple, the most commonly cited statistic is the multiple of 400.
2. Including Peter Drucker; see the Drucker Institute (2011).
3. Publicly traded firms are beginning to move away from this practice. The Council of Institutional Investors (2011, 11) and The Conference Board (2009, 9, 20–22) have recommended against giving executives benefits richer than those provided to other employees.