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## How Much is Too Much? A Theoretical Analysis of Executive Compensation from the Standpoint of Distributive Justice

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In analyzing the ethics of executive compensation, this paper examines the issue from the standpoint of three prominent theories of distributive justice. Applying each of these "ideal" theories to the question of how to structure CEO pay illustrates a variety of different objections and considerations. Surveying the theories together in one analysis – rather than considering each one independently – reveals a certain amount of common ground among them. The theoretical analysis reveals a convergent conclusion about the importance of open and fair executive selection and compensation-setting *processes* to the establishment of an ethically appropriate level of executive pay.

**Keywords:** executive compensation, distributive justice, business ethics, political philosophy, stakeholder theory

### Introduction

The level of executive pay has skyrocketed over the past several decades, widening the gap between the compensation of CEOs<sup>1</sup> and that of typical organizational employees. Although there exists a traditional underlying rationale for highly

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<sup>1</sup> In this chapter, I use the terms "executive" and "CEO" interchangeably.

paid executives within the corporate community, the business validity of high CEO pay is coming under increasing scrutiny. In addition, there is a rising tide of opposition to lavish executive compensation from outside the business community that also suggests such compensation as objectionable. But on what grounds are such objections based? How much is too much? Although exorbitant amounts of executive remuneration might simply seem absurd from a common sense standpoint – especially to corporate outsiders – an analysis that incorporates the major theories of distributive justice is extremely useful in framing a more comprehensive, normative picture of executive pay. Rather than an in-depth treatise on one particular political philosophy, this chapter surveys three major theories of distributive justice, applying them each specifically to the question of how corporate executives ought to be paid.

## Background

Executive pay has recently increased dramatically, widening the disparity between the compensation of top managers and typical workers (Lublin, 1996; Young, 1998; Useem, 2003). The notion that managers should be given sizeable incentives in order to increase a company's chance for success has a long history (e.g., Patton, 1951), and its continued prevalence reflects a "best practice" promoted by business academics and consultants. For example, Jensen and Murphy (1990) issued a well-known call for increased CEO incentive compensation via stock options, warning that otherwise, executives would behave as bureaucrats. As if in answer to this call, total compensation for executives in the United States steadily rose over the next decade, jumping from 100 times the pay of a typical worker in 1990 to somewhere between 350 and 570 times the pay of a typical worker, primarily through the use of stock options (Rynes & Gerhart, 2000; Hall & Murphy, 2003). Whether or not this trend is attributable to the influence of specific commentators, the underlying rationale for increased executive pay has remained the same, namely, increased contingent pay – when tied to a firm's stock price – is the best way to "align the incentives" of stockholders and top managers.

Aligning the incentives of these two groups is a sought-after attempt to solve the "agency problem" of executives pursuing their own interests at shareholders' expense (Jensen & Meckling, 1976). Managers, in other words, ought to be given incentives to increase economic returns to shareholders. Some scholars (e.g., Friedman, 1970) argue – from what is essentially a property rights perspective – that this represents an absolute fiduciary duty; managers must *only* and *always* act in the interest of those shareholder owners. In this tradition, others (e.g., Jensen, 2002) buttress this argument by explicitly suggesting the presence of the underlying

utilitarian notion that maximizing shareholder profits is the way to improve a society's overall social welfare; from this point of view, high levels of executive pay are merely a way to ultimately achieve the greatest good for the greatest number, and the ends justify the means.

However, a number of economic experts and business academics are questioning the effectiveness of incentive pay in resolving the agency problem and providing the desirable business and societal outcomes. For instance, Bebchuk and Fried (2003) argue that, while executive compensation is typically viewed as a potential solution to the agency problem, it is in fact likely to be part of the agency problem. In this sense, excessive pay for executives may actually cause, rather than solve, managerial problems. Noted economist Hal Varian (2002) recently recognized that, given the powerful incentive provided by stock options, "the temptation to inflate stock prices artificially will also be strong." Nobel Laureate Joseph Stiglitz argues that high-powered incentives and stock options give executives "more incentive to misreport (corporate) incomes" (Meyers, 2003). In support of these ideas, researchers have empirically examined the link between high levels of CEO incentive compensation and the likelihood of financial misrepresentation, finding that such malfeasance is increasingly likely as the level of incentive compensation rises (Harris & Bromiley, 2003; O'Connor et al., 2003).

In addition to this emerging view from the scholarly community, it appears that the tide of public opinion also largely opposes ballooning executive pay. In the aftermath of several years of large corporate scandals – many involving executive compensation – a diverse range of voices are increasingly expressing their objection to large CEO rewards. In a recent study, for example, focus groups comprised of "ordinary Americans" expressed outrage over burgeoning CEO pay, especially during times of employee cutbacks – citing greed as the source of the problem (Farkas et al., 2004). For a more specific case, consider the ousting of former New York Stock Exchange executive Richard Grasso, who was not only forced to resign over the size of his compensation package, but is now being sued by the state of New York for the recovery of a portion of that "unreasonable" pay (Thomas, 2004).

Yet despite the abundant attention and dialogue given to this issue, the questions remain: What determines whether or not a certain level of executive compensation is reasonable? How can a justifiable level of CEO pay be determined? In order to advance the discussion and provide some tentative answers, I analyze the issue of executive compensation from the standpoint of distributive justice, drawing upon three core theories of several notable political philosophers. Although each theory raises slightly different objections to exorbitant executive pay, they interestingly lead to a convergent conclusion about how CEO compensation ought to be determined.

## **Analysis**

An analysis of the implications of distributive justice for executive compensation would be incomplete without examining the field's most important theories, including John Rawls' theory of justice as fairness (1971), the capabilities-based approach of Amartya Sen (1999) and Martha Nussbaum (2000), and the libertarian theory of Robert Nozick (1974). Although all of these works are ideal theories, they are invaluable in framing a variety of substantive objections to lavish executive pay. Understanding these theoretical objections in turn paves the way to a normative conception about how executive pay ought to be structured. Since none of the theories claims to be a "complete" or "full" theory, each of them is considered in turn, in an effort to construct an integrative conception of the challenges and potential solutions associated with the structuring of executive compensation. This integrative discussion follows the three respective theoretical analyses.

This theoretical study of the ethics of executive compensation, as outlined, could be conducted at several different levels of analysis. For example, using the ideal theories as a framework might immediately call to mind a host of expansive, global considerations for multicultural political economy and the role of the state in multinational business and societal infrastructure. However, the approach taken here is a stricter, more focused level of analysis centering on the firm and its primary stakeholders (Freeman, 1984). Since the firm's principal stakeholders include shareholders, employees, customers, suppliers, and the social community in which the organization resides (Phillips, 2003), an analysis of the distributive justice implications of executive compensation within this "mini-society" provides a meaningful boundary condition on the analysis without limiting the dialectical nature of the contrasting stakeholder interests. A stakeholder analysis of executive compensation, therefore, serves as a useful model for a greater societal analysis, but also helps to bridge the gap between abstract ethical ideals and practical business constraints (Sen, 1997). In the context of this chapter, the analysis also serves to apply and extend stakeholder theory.

### ***Justice as Fairness***

Through the use of a carefully conceived thought experiment called the "original position," John Rawls derives two fundamental principals of justice. These are the key criteria in establishing distributive justice. Therefore, the critical task of a

Rawlsian analysis of executive compensation is to determine which, if either, of these principles is likely to be violated in situations of high CEO pay, and if so, under what circumstances. Although Rawls articulates the two principles in a variety of slightly different ways, his initial formulation of them reads as follows:

First: each person is to have an equal right to the most extensive scheme of equal basic liberties compatible with a similar scheme of liberties for others.

Second: social and economic inequalities are to be arranged so that they are both (a) reasonably expected to be to everyone's advantage, and (b) attached to positions and offices open to all. (1971: 53)

I focus on the second of Rawls' principles, since the most intuitive objections arise from this principle, with its two parts. In fact, the first part (or "difference principle") is what many common objectors to high CEO pay appeal to – perhaps unknowingly – in voicing objections based on, for example, the disparity between executive and entry worker salaries. The objection, in Rawls' framework, is that at least some of the least well off among the corporation's stakeholders – in this case, hourly workers – are not really made any better off by handsomely paying the CEO. Such an objection can certainly be applied to other stakeholder groups; for example, high executive pay is also seen as a drain on returns that could otherwise be returned to shareholders (e.g., Bavaria, 1991; Monks & Minow, 2004: 262–274). The "least well off" among a firm's stakeholders may also include customers, suppliers, and the social community in which the organization resides, for which the same question remains salient: from the standpoint of the difference principle, is a high amount of CEO pay defensible if the least well off would benefit from the CEO being paid less?

An analysis of the difference principle, then, quickly becomes a question of allocation – whether a certain dollar amount is best paid to the CEO, or distributed in some other fashion to the firm's stakeholders. If it could be shown that an arrangement to pay the firm's executive \$100 million in annual compensation leads to at least slightly better pay for the lowest paid worker – or to marginally better quality in the consumer product produced, or to slight increases in the public goods of the community in which the firm resides – than other pay arrangements in which the CEO receives less, then the difference principle might be satisfied. Those who defend high levels of executive pay often argue that this is in fact the case, invoking the social welfare argument that a rising tide lifts all boats. In other words, incentives at the top should create benefits at the bottom, and in the process of doing so, satisfy the demands of both Friedman and Rawls. The presumed mechanism for such a process is that executives with

proper incentives will raise the overall performance level of the organization, leading to greater profits that not only reward the CEO, but also trickle down to the least well off among the firm's stakeholders.

One gap in such a defense of high executive pay is that there is no real mechanism for the trickle down. Why should we assume that *increased* profits would be any more likely to distribute down to non-executive stakeholders than profits that are *not* increased? Setting that aside, the even greater problem is that a number of studies have had difficulty showing a link between executive incentive pay and better performance for the firm (Murphy, 1999; Mishra, *et al.*, 2000; Blasi & Kruse, 2003)<sup>2</sup>, and some even show that it leads to fraud or financial misrepresentation (Harris & Bromiley, 2003; O'Connor *et al.*, 2003; Schnatterly, 2003). So regardless of whether or not there is any mechanism to more justly distribute increased profits to various stakeholders, it is not at all clear that handsome rewards for executives lead to a general increase in profits in the first place. The tide may not be rising at all. Unless such a clear connection can be shown, along with some level of visibility into the corresponding mechanism intended to distribute some portion of the gains to the firm's stakeholders who are least well off, instances of high levels of executive pay are likely to violate the difference principle.

Rawls' second principle of justice also encompasses, in addition to the difference principle, the notion of "open position," or fair equality of opportunity. I argue that high levels of executive compensation are likely to be associated with a violation of this aspect of Rawls' theory as well. Because Rawls himself stipulates that the standard of open position have priority over the difference principle, this means that – from the standpoint of justice as fairness – an executive compensation arrangement violating fair equality of opportunity is even more problematic than one whose objection arises only from the difference principle.

Whereas applying the difference principle to executive compensation issues would focus on the distribution of wealth to executives versus the stakeholders who are least well off, applying the open position standard to questions of

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<sup>2</sup> Not only is there no clear link between high executive incentive pay and positive firm performance, some studies indicate worse performance. For example, Blasi and Kruse (2003) find that from 1993 to 2001, the one quarter of companies that gave the smallest shares of options to top management gave their investors a 31.3% annual return. Shareholders of the one quarter of companies that gave disproportionately to top executives received only a 22.5% return. In addition, related work on costly managerial prerequisites also supports this idea; Yermack (2004) finds that CEOs' personal use of company aircraft is associated with substantial and significant under-performance of their firms' stocks.

executive compensation is primarily concerned with how such pay is determined, and whether or not the CEO position itself is truly accessible to all. One may, as Rawls explains, construe a motive for open position based upon an efficient application of the difference principle – that fair equality of opportunity is the efficient way to find the most talented person for a particular job, who will then tend to do the best job possible in that position, in turn benefiting everyone else the most, including the least well off – but Rawls clearly rejects this notion in favor of a much more primal reason to uphold the ideal of open position:

if some places were not open on a basis fair to all, those kept out would be right in feeling unjustly treated even though they benefited from the greater efforts of those who were allowed to hold them. They would be justified in their complaint not only because they were excluded from certain external rewards of office but because they were debarred from experiencing the realization of self which comes from a skillful and devoted exercise of social duties. They would be deprived of one of the main forms of human good. (1971: 73)

Therefore, an analysis of an executive compensation arrangement from the standpoint of justice as fairness must not only look at the compensatory distribution itself, but also address whether or not the determination of the CEO's pay – as well as the very process of selecting that executive in the first place – satisfies the standard of fair equality of opportunity.

With respect to the actual filling of executive positions, anecdotal accounts of conflicts of interest, revolving door hiring practices, and closely interlocking boards of directors – where one CEO serves on another's board, and vice versa – suggest a system that appears to favor reciprocity as much as ability. Such ideas have found scholarly support; for instance, Davis *et al.* (2003) explore evidence that corporate America is overseen by a relatively small network of executives who to a great extent have social connections or acquaintances in common – and that these board ties have a big impact on issues of corporate governance. One of these issues is the setting of executive pay; compensation committee members with close relationships to CEOs have been shown to be typically more benevolent in awarding compensation than those members with more distant relationships (Young & Buchholtz, 2002), suggesting the presence of strong norms of reciprocity within the boardroom. Westphal and Khanna (2003) study the downside of ignoring such norms, finding that board members who act to defy or limit CEOs' power are subject to sanctions and ostracism. Consequently, while believers in corporate meritocracy might be more sanguine about the chances of those with more ability consistently rising to the top, the picture is at best mixed. At the

least, it could scarcely be argued that all (or even most) executive positions are filled in a way that makes the opportunity truly accessible to all.

Furthermore, once appointed, how is an executive's compensation determined? Although some have suggested that handsome compensation duly rewards the complexity of the executive's duties (Henderson & Fredrickson, 1996) or mitigates the CEO's personal risk (Chung & Charoenwong, 1991), consider some of the other factors that have been shown to positively influence the size of executive pay packages: CEO celebrity or notoriety (Rosen, 1981; Porac *et al.*, 1999; Hayward *et al.*, 2004), "bandwagoning" or the use of popular management techniques (Staw & Epstein, 2000), and the dominance of insiders or friends on an executive's compensation committee (Conyon & Peck, 1998). In addition to such insiders, the executives themselves routinely sit on their own compensation committees, essentially facilitating pay packages for themselves of ever-increasing generosity. I suggest Rawls might say that such things are clear indications that the demands of fair equality of opportunity have been frustrated.

One way this might be commonly envisioned is in terms of the value proposition of the CEO to the firm; presumably, one of the outcomes of true fair equality of opportunity is that the best person should ultimately get the job. Granted, Rawls supports open position not because such a person would better "deserve" the corresponding rewards, but rather because such a process is essential to the Rawlsian conception of what is valuable to humans. Yet when viewed from the reverse direction, the value proposition lens might lend insight; someone who is being compensated beyond what their talents reasonably deserve is very likely the product of a selection process that violates open position. So while the existence of an executive who is clearly qualified for (or "worth") a large pay package is not necessarily a guarantee that the process was open, a CEO who is clearly overpaid relative to his or her endowments is a signal that the process has somehow shortchanged fair equality of opportunity. The difficulty, of course, remains in identifying an answer to the initial question of whether a given CEO is in fact overcompensated. Justice as fairness provides one potential framework for beginning to resolve this question.

In a recent cartoon (see Figure 4.1), the character Alice confronts her CEO on this very issue: is there reasonable justification for his excessive pay? Although Alice is immediately satisfied when she sees the CEO produce a golden egg, justice as fairness would require additional inquiry. In order for us to know if the compensation package for the gold-producing executive satisfies the difference principle, we need to verify that the least well off among the firm's stakeholders



Figure 4.1 Golden eggs and appropriate CEO pay (Used by permission).

stands to benefit more from the arrangement than from some other executive pay structure. In order for us to know if the compensation package of the gold-producing executive satisfies fair equality of opportunity, we need to establish whether the process for selecting him and setting his compensation was just and accessible to all. Was the CEO position open to other people with the ability to lay golden eggs? Would any of the other egg layers produce the same amount of eggs for a lesser compensation package? Or was this particular egg-laying CEO simply more of a celebrity, or did he have friends or sympathizers on the board's hiring and compensation committees? These are the types of questions that need to be examined with respect to real-world compensation scenarios, in order to determine what kind of pay is justified for business executives according to justice as fairness. In conducting such an analysis, the two key tests – and consequently Rawls' biggest potential objections – in establishing a morally justified executive pay package are the difference principle and the standard of open position.

### **The Capabilities Approach**

Amartya Sen and Martha Nussbaum approach questions of distributive justice somewhat differently from Rawls. For example, their perspectives are much more intuitionist in nature than the constructivist approach of justice as fairness. Although their conception of the person is roughly similar to that of Rawls, it includes some ideas that are almost Aristotelian; a conception that views people as agents who have a hand in their own destiny, who have many and diverse interests,

who require freedom to achieve their own version of a valuable life, and who are all equally interested in and deserving of such ideals. As such, these theorists' approaches to human development and justice center primarily on human capabilities and freedoms.<sup>3</sup> Freedoms, in this view, are essentially the capabilities to do the things that are central to this conception of personal development and fulfillment. In their respective treatises, both Sen and Nussbaum explore their principles largely within the context of the developing third world, but as with the prior discussion of Rawls, I here adopt the more narrow boundary condition of applying their ideas to executive compensation within the context of a company's primary stakeholders.

Analyzing executive compensation from the standpoint of the capabilities approach essentially means that one must view CEO pay through a singular critical lens: in terms of its role in capability enhancement or deprivation for the firm's stakeholders. In general, such an analysis boils down to the following assessment: if the capabilities of a firm's stakeholders do not currently meet an adequate threshold, then it will be very hard to justify additional or excess compensation for the firm's executive.

Therefore, the critical question then becomes: what are the freedoms or capabilities that should be considered? Sen proposes five different types of instrumental freedoms that lead to the development of valuable human capabilities: political freedoms, economic facilities, social opportunities, transparency guarantees, and protective security (1999: 39–40). Nussbaum takes a slightly different angle in identifying the essential capabilities themselves; she categorizes them into 10 different areas: (1) life, (2) bodily health, (3) bodily integrity, (4) senses, imagination, and thought, (5) emotions, (6) practical reason, (7) affiliation, (8) co-existence with other species and the natural world, (9) play and recreation, and (10) control over one's political and material environment (2000: 78–80).

One of the key themes of the capabilities approach, as made clear by the authors' broad lists of the essential capabilities and freedoms, is that income (or economic wealth) alone is an insufficient way to conceive of and measure human well-being. From this standpoint, any distribution of economic wealth should be predicated on – and valued for – the ability of such income to facilitate needed capability enhancements for individuals. Yet individuals clearly vary in their own personal circumstances and physical characteristics; they also exist within varying

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<sup>3</sup> Despite fine-grained differences in the theories of Sen and Nussbaum, they are sufficiently similar and complementary that I consider them together for purposes of this chapter.

environmental conditions and social climates (Sen, 1999: 70–71). This means that:

The contrast between the different perspectives of income and capability has a direct bearing on the space in which inequality and efficiency are to be examined. For example, a person with high income but no opportunity of political participation is not “poor” in the usual sense, but is clearly poor in terms of an important freedom. Someone who is richer than most others but suffers from an ailment that is very expensive to treat is obviously deprived in an important way, even though she would not be classified as poor in the usual statistics of income distribution. A person who is denied the opportunity of employment but given a handout from the state as an “unemployment benefit” may look a lot less deprived in the space of incomes than in terms of the valuable – and valued – opportunity of having a fulfilling occupation. (Sen, 1999: 93–94)

While highlighting the intuitive attractiveness of appealing to human capabilities in deciding questions of distributive justice, this also indirectly highlights one of the challenges in applying the capabilities approach: because of the wide heterogeneity of personal situations and conditions, it is difficult to be sure when a threshold level of functioning has actually been realized. It is also unclear – assuming the possibility of a situation in which such a basic threshold capability level is nominally achieved by all relevant stakeholders – what the distributive ordering scheme should then be, and what the duties for distribution and capability enhancement are at that point.<sup>4</sup> Sen and Nussbaum would likely contend that such an optimistic scenario is highly unlikely, even within the boundaries of an American corporation and its stakeholders; and if so, some of the money earmarked for executive pay might otherwise be put to use in offsetting capability deprivations or enhancing the positive freedoms of the firm’s other stakeholders.

Therefore, from the vantage point of the capability approach to distributive justice, the primary objection to high CEO pay will arise when a company executive is being highly compensated while other stakeholders are languishing below a baseline level of human functioning. In order to levy such an objection, one

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<sup>4</sup> By focusing on the developing third world, Sen and Nussbaum forestall the immediate need for them to address such questions of ordering. They illustrate their theoretical points with clear and obvious examples of capability impoverishment and gross limitations on freedoms, essentially asserting that, given the abundance of such massive capability deprivations throughout the world, an additional, nuanced consideration of a distribution to those already possessing an adequate threshold level of functioning is a secondary task. This creates a challenge for an analysis like this one, where such parity may be a more achievable state than Sen and Nussbaum envision in their ideal, global theory.

would have to directly examine the capabilities of the firm's stakeholders. For example, if contract workers in an overseas manufacturing facility are being subjected to unsafe working conditions, or are not being paid a living wage, then several of their primary human freedoms are likely to be in jeopardy. Alternatively, if a domestic employee, a single mother, is given a difficult work schedule and a low level of compensation such that it is difficult for her to financially and emotionally care for her handicapped daughter, then several important capabilities might clearly not be met. If a firm's factory emissions are contaminating a community's water supply or air quality at levels that endanger or degrade human health, residents of that community suffer from a certain amount of capability deprivation.

Within the capabilities framework, these are precisely the types of considerations to contemplate in deciding how large the CEO's annual compensation should be. This view highlights an organization's obligation to attempt to enhance the capability needs of the firm's other stakeholders. For example, the firm's responsibility to address the capability needs of the employee stakeholder group could be envisioned as follows:

Organizations . . . have an obligation to provide work and compensation that leave employees with the energy, autonomy, will, and income to pursue meaning at work and a meaningful life outside of work. (Ciulla, 2000: 226)

Assuming that one can recognize whether various stakeholders' freedoms are inadequate, as well as how the insufficient capabilities in question might be enhanced, large amounts of CEO pay are problematic; portions of a \$300 million compensation package are likely to go a long way toward offsetting a host of capability problems among a firm's other stakeholders, be they shareholders, employees, community residents, suppliers, or customers. Indeed this would be a moral obligation, from a capabilities approach standpoint. This constitutes the primary objection to high executive pay within the capabilities framework: to the extent that other stakeholders are deficient in realizing essential human freedoms, high amounts of CEO compensation should be redistributed in a meaningful, capabilities-enhancing way.

In addition to this central objection, I draw attention to another specific objection that arises from one of the particular areas of human capability. Hiring and compensation in the executive suite will run afoul of the capabilities approach to the extent that the filling of executive position and setting of pay level is an opaque process hinging on social connections, rather than an open process decided on merit and ability. Similar to the Rawlsian standard of fair equality of opportunity, the capabilities framework for distributive justice requires that individuals have

“the right to seek employment on an equal basis with others” (Nussbaum, 2000: 80). In other words, if high levels of executive pay are an indicator that the CEO “old boy’s club” is exclusive and favors the advancement of cronies while limiting the opportunity for other qualified candidates to seek executive positions, then justice will have been compromised. As with the Rawlsian objection of open position, a closed hiring process affects the actual stakeholders of the organization to the extent that it escalates pay for the executive and – in this case – shifts resources from other initiatives that might otherwise be capability enhancing. Central to this argument is the notion that income is important only to the extent that it enables capability enhancement, and in that sense is essentially a means to an end. There is no argument within the capability approach for income transfer solely for the purpose of wealth accumulation; in fact, there are clear examples of a disconnect between the two, wherein wealth transfer alone is not able to sufficiently mitigate a capability deprivation. Sen’s (1999: 28) purpose in discussing the case of well-cared-for slave laborers who chose freedom over income, for example, is to accentuate that human capabilities are much more important than money, and that one does not always lead to the other. Therefore, this particular capabilities-based objection relates to high executive pay only with respect to what it might represent: a closed process of filling the executive positions in the first place. In order to satisfy the demands of the capabilities approach, such positions should be open to all, providing each potential candidate for an executive position – as with all candidates for other, non-executive positions – an “equal starting place” from which to prove their merits for the position (Werhane & Radin, 2004: 171).

In summary, the capabilities approach entails several requirements that constitute two potential objections to the way executives are employed and compensated. These might be summarized into two questions: (1) Is the executive highly paid, despite other stakeholder capability deficiencies? and (2) Is the level of executive pay an indicator that the process of CEO selection is something less than an open process, providing equal opportunity to all? From the standpoint of the capabilities approach, these are the questions that need to be examined with respect to real-world scenarios, in order to determine what kind of hiring practices and pay are justified for business executives.

### ***Libertarian Theory***

In his theory of distributive justice, Robert Nozick (1974) focuses primarily on liberty with respect to property, for the most part leaving other capabilities and considerations out of his theory. Nozick argues, essentially, that nothing beyond

a so-called minimalist state – that protects its members from force or fraud – is justified. The base assumptions of Nozick’s libertarianism are justice in acquisition and justice in transfer. In fact, these assumptions really represent the very core of the theory, and are the replacement for other “patterned history” schemes of distributive justice that are represented, in Nozick’s view, by other nonlibertarian theories (e.g., 1974: 156–157). Simply put, if everyone is justly entitled to the distribution of property they actually have – that is, the goods have been obtained through “justice-preserving” means of acquisition and transfer – then the demands of justice are satisfied and there is no further need to examine distribution amounts, inequities, or redistributions (1974: 151). Assuming an initial fair distribution, free market forces are proposed as the best way to govern future transfers, and actual distribution inequities are irrelevant as long as they are fair.

On the other hand, Nozick explicitly raises the point that, in the real world, these underlying assumptions sometimes do not hold:

Some people steal from others, or defraud them, or enslave them, seizing their product and preventing them from living as they choose, or forcibly exclude others from competing in exchanges. None of these are permissible models of transition from one situation to another. And some persons acquire holdings by means not sanctioned by the principle of justice in acquisition. (1974: 152)

He goes on to explain how these problems give rise to the sticky dilemma of past injustices and how to correct for such things. Despite raising this issue, however, Nozick quickly retreats back to the territory of his ideal theory, offering as a solution only the mere possibility of an unspecified “principle of rectification” that would “presumably” remedy such situations (1974: 152–153).

Although this raises a number of interesting theoretical questions, further analysis of Nozick’s libertarianism is unnecessary because at this point we already have a clear picture of his potentially strong objection to CEO compensation: that the determination and distribution of such compensation might not meet the standards of justice in acquisition and justice in transfer. All of the subsequent libertarian tenets – individual responsibility, free and unfettered market transfer mechanisms, individual consumer liberty – cannot even be meaningfully applied to questions of executive compensation if the process of paying CEOs violates justice in acquisition or transfer. These underlying principles must hold in order for Nozick’s theory to have any further analytical efficacy. If these principles can be shown to have been violated in the case of a particular executive’s over-generous pay package, then they become the libertarian viewpoint’s primary objection to that particular instance of a high level of executive compensation.

In this view, the process for determining and distributing executive compensation must be just. Because Nozick argues that a thief is not entitled to his ill-gotten gains, it follows that executives who use an insider's advantage to enrich themselves at the expense of other stakeholders also do not attain just entitlement; such a situation scarcely looks like free exercise of liberty in action. From this standpoint, it is not the disparity (or result) of the pay distribution that fuels the objection; rather, the process that is less than fair and transparent. Recall the case of Richard Grasso; the state of New York is attempting to recover a portion of Grasso's compensation because he is perceived to have allegedly exploited his position by deceiving his compensation committee about the details of his pay package (Thomas, 2004), a process deemed to be unfair. Although some might casually invoke Nozick's famous Wilt Chamberlain thought experiment<sup>5</sup> to defend those (like many CEOs) who receive large incomes, a close examination reveals that the key mechanism in this example is the unfettered, fully informed liberty exercised by the fans who willingly, freely choose to pay extra in order to watch Wilt play. It is an ultimate stylized example of a free market in action. In contrast, it is hard to imagine a similar libertarian defense of Wilt's extra income distribution under altered hypothetical conditions, in which the extra income is channeled to Wilt via back-door dealing or unjust appropriation – an arrangement that his fans would undoubtedly object to, were they aware of it. Therefore, to the extent that an executive compensation-setting process falls short of attaining true liberty, transparency, and voluntary acquiescence by the stakeholders concerned, the libertarian framework suggests that such a process is unjust.

There is an additional libertarian objection that arises from Nozick's theory, unrelated to the objection of unjust process, which is also suggested by the example of Wilt Chamberlain. In this example, Wilt's extra earning power at the ticket office arises because he is "greatly in demand by basketball teams," presumably because of his unique – or at least, extraordinary – abilities as a player (Nozick, 1974: 161). A legitimate question is whether such an example can be generalized to situations of corporate executives.<sup>6</sup> Undoubtedly, many executives would

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<sup>5</sup> The example is used by Nozick to show the futility and irrelevance of an appeal to equality of *distribution*; in the hypothetical example, Wilt Chamberlain signs a contract to the local team by which he gets an extra 25 cents for each ticket sold. One million spectators buy tickets that season, resulting in extra payments to Wilt of \$250,000. Nozick argues that nothing is wrong with this inequity; Wilt is fully entitled to that extra distribution because the fans voluntarily transferred it to him, and were happy to pay the sum in return for the pleasure of watching him play.

<sup>6</sup> Ronald Dworkin (2000: 111–112) argues that the Wilt Chamberlain example – while acceptable in its stylized form – is scarcely generalizable at all to any actual, real-world societal contexts.

argue in the affirmative. Yet the cartoon with Alice and the golden egg-laying CEO suggests – albeit in a tongue-in-cheek way – that executives may not in fact be worth their exorbitant pay unless they can do something as incredible as lay golden eggs.

This echoes the “value proposition” point of view discussed earlier in connection with Rawls’ principle of fair equality of opportunity. Ignoring for a moment the question of whether the distribution process is just, at the very least we ought to critically question whether extremely well-paid CEOs truly bring unique – or even extraordinary – value to their positions. The answer may be in some cases yes, and in other cases no, but generally speaking, it is far less clear that highly paid corporate executives embody the kind of exceptional value proposition represented by Wilt in the stylized example. In fact, executives are often paid well regardless of poor corporate performance (e.g., Mishra et al., 2000), and even – through the use of “golden parachute” exit contracts – in situations where they leave in disgrace (Brin, 2002; Lublin & Hechinger, 2002). The notion of connecting CEO compensation to an appropriate value proposition is an essential part of the complaint against Grasso: the exchange was led by other competent leaders prior to him, is currently being led by a new competent leader, and although he may have provided solid leadership, he was ultimately too replaceable to command such inordinately high remuneration (Surowiecki, 2003). In other words, Nozick’s thought experiment would hardly make any sense at all if he had chosen to illustrate it with a third-string, unknown collegiate player instead of a storied professional superstar like Wilt Chamberlain.<sup>7</sup>

The assumptions of justice in acquisition and justice in transfer provide the foundation for Nozick’s libertarian theory of distributive justice, requiring that the processes of executive compensation determination and distribution – if they are to be considered morally defensible – be just and fair. In addition, the primacy of liberty and market mechanisms within the theory demand that executives be not paid beyond their value proposition. From a libertarian perspective, these are the critical factors that need to be examined with respect to actual executive compensation scenarios, in order to determine what kind of pay levels are justified for particular business executives.

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<sup>7</sup> Alternatively, if one strongly believes in the efficacy of free market mechanisms, as Nozick does, the value proposition objection could also be envisioned simply as another aspect of the just process objection. If the market mechanisms for CEO compensation were truly free, transparent, and unfettered, then executives would only be able to command the incomes commensurate with their true value propositions. If the processes of acquisition and transfer could be trusted to be just, then the problem of CEOs being paid beyond their value proposition might theoretically take care of itself.

## Discussion and Conclusions

The three major theories of distributive justice highlighted in this chapter raise a number of potential objections to high levels of executive compensation. This is not surprising, given that the theories arise from widely divergent political philosophies. In common political parlance, for example, the three frameworks – fairness doctrines, human development efforts, and libertarian approaches to policy – are generally seen as being very different in their standard dogma and perceived ramifications. One might expect such substantially different theories of distributive justice to produce starkly contrasting critiques or conclusions with respect to a specific issue like executive compensation. In academic research, strong conclusions are often drawn from one theoretical framework, because multi-theoretic analyses of specific issues can result in an intractable stalemate. Indeed, other multi-perspective philosophical analyses of executive compensation have proven inconclusive (Nichols & Subramaniam, 2001).

It is therefore a constructive outcome of the analysis that such a strong common theme emerges from applying each of these three ideal theories to the question of justice in executive compensation. In this case, each theory produces a central requirement that the *processes* governing executive selection and/or compensation be just; otherwise, high levels of pay for executives cannot be justified. In Rawls' theory of justice as fairness, this arises from the principle of fair equality of opportunity. Similarly, the capabilities approach to human development requires the essential human freedom to seek employment on equal basis with others. From Nozick's libertarian vantage point, justice in acquisition and transfer must undergird all distributions of wealth or property in order for one's entitlement claim to be justified. It is clear from these theoretical objections that the processes of choosing and setting compensation for executives must approximate the type of fair, open, market mechanisms that would satisfy all three frameworks.

A closely related way of envisioning this theme emerges from Rawls and Nozick: that executives should be paid commensurate with the true value proposition they bring to the organization. For justice as fairness, executives paid beyond their true value proposition will be objectionable to the extent that their compensation level arises from the standard of fair equality of opportunity having been compromised. In a similar manner, a libertarian framework allows for extraordinary performers to receive exceptional incomes, provided that those individuals are indeed truly outstanding and the associated income transfer represents a fully informed choice. In this sense, one of the outcomes of a just process for selecting executives and determining their pay is a more open and accurate appraisal of their value propositions.

The questions then become: to what extent is this convergent theoretical objection to unjust processes in CEO selection and compensation a valid one in today's actual world of executive pay? And if so, what can be done? One indication of the validity of this theoretical concern is the corresponding evidence from management scholars, some of which was previously discussed in this analysis. In some cases, these studies shed an unflattering light on a process that is beset with conflicts of interest and reciprocal currying of favors. In other cases, the evidence is less damning but still serves to illuminate a process that appears to be inadequately transparent, open, or free. All of this means that we may be "kidding ourselves" by assuming that "free enterprise is at work in our boardrooms when it really is not" (Bavaria, 1991: 11). Although the prevalence of discernible process problems does not imply their universality, it does suggest that significant numbers of boardrooms fall short of meeting a standard that is individually demanded by three very different theories of distributive justice.

The implication of this theoretical convergence is that the processes of executive selection and compensation should occupy a focal area for governance scholars and those concerned with the ethics of executive compensation. For such scholars, a thorough examination of executive selection and compensation *processes* represents a productive course of future research that may lead to a better understanding of how these processes can be improved and made more transparent and open. This may ultimately pave the way to the establishment of consistently appropriate and ethically sound executive compensation arrangements.

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