

# The ethics of executive compensation in the Canadian public health system

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**Abstract**—The method of executive compensation in the Canadian public health system presently contains complex ethical issues related to transparency and fairness, not only within single organizations, but across provinces, and in comparison with other wage earners. The increasing interest of the public, elected officials, and health decision makers in public sector compensation will bring heightened scrutiny and intervention in the future. This article explores some of the current ethical issues of executive compensation and their implications and points to reform initiatives for the future.

Few topics have come under more scrutiny following the worldwide recession of 2008 than the ethics of executive compensation. The motivations and incentives around corporate compensation in the financial sector are widely seen as having contributed to this crisis and have sparked a spate of reform initiatives intended to avoid a reoccurrence.

Things have certainly changed since the earliest days of barter where commodities were exchanged for services rendered. Undoubtedly, under this model, physicians accepted their share of chickens and barley in return for healing care. Implicit in this exchange was the sense of the equivalence of value in the goods and services which each party saw as a fair trade. Today the complexity of executive compensation transactions has led to a myriad of ethical dilemmas around fairness and incentives.

## CONTEXT

For this discussion, total compensation is intended to include all forms of transaction that are received in return for time and services. In the Canadian healthcare context, cash compensation and benefits for publically funded executives are generally less wide ranging than those accorded to corporate executive counterparts. Total corporate compensation typically includes some or all of the following: salary, often with a component for performance bonus or pay at risk, pension plans and possibly supplementary pension plans that supersede the standard threshold income maxima, medical, dental, and life insurance and disability benefits, a variety of prerequisites ranging from the corner office to automobile and parking coverage, health club memberships, access to communication technologies, professional development, enhanced vacation

entitlements, spousal entitlements such as travel and assistance with employment, expense accounts including the entertainment of guests and dignitaries, relocation and signing bonuses, legal fees for review of the employment contract, loans, termination clauses, and, in the corporate sector, stock options and grants for stocks, profit sharing, and use of the corporate jet.

The compensation plan is usually spelled out in a hiring contract document which may be on a renewable term or ongoing. A performance review process is also usually detailed and is to be regularly conducted by the Board of Governors, or direct supervisor, often with input from others. Although all of this sounds straightforward, there are numerous areas where ethical questions may arise.

## ETHICAL CONSIDERATIONS OF COMPENSATION

The most obvious area of ethical concern is around the actual amount of cash compensation an executive receives and whether the quality and quantity of work is commensurate with the compensation received. Today the measuring sticks are not as simple to apply as in the early days of barter. Moreover, even if an organization has established criteria to guide compensation decisions, the fairness of compensation, that is, the valuation of worth, often lies in the "eye of the beholder." There are ethical perspectives associated with compensation decisions. It can make a difference "who" the person is that evaluates the compensation, including the evaluator's personal morals, values, and sense of what is fair, and even how the person whose compensation is being evaluated is perceived. For instance, a risk of introducing bias into compensation review decisions can occur if there is a personality clash between the employer and employee, but that employee is actually doing a good job by measurable criteria in the eyes of others.

When boards and supervisors are called upon to evaluate a subordinate's performance, it requires that proper homework be done using established criteria and benchmarks. Likewise, these criteria need to be equally clear to

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the employee. If a performance review system purports to allow a percentage increase for top performers, then the employees need to observe that this standard is in fact being followed. If the performance system becomes a function of whatever cash is available at the year end, and that amount is rationed out to a few of the top people, then the performance plan falls short of employee expectations and they learn to distrust the organization.

Bloom<sup>1</sup> in his 2004 article on compensation ethics points out the central importance of fairness in compensation; indeed the very perception of fairness by employees is extremely important. In fact, the specific way employees are compensated, along with the perception of fairness of that process, may be even more important than the actual amount of compensation. A workplace can become demoralized by perceived holes and inequities in the compensation process, which can lead to questions about the morals and values of the organization itself. Examples include actual or perceived favouritism or bias by the supervisor in assessing performance and compensation and starting rates of pay that differ for the same job. A new employee who starts at a rate that exceeds that of existing staff owing to tight labour pool market conditions can cause issues in the office, as can the flip side situation where a supervisor doing a more responsible role incurs compression in respect to her or his employees.

This backdrop on ethical fairness is important when examining the compensation of the top Chief Executive Officers (CEOs) in Canada and the United States today. Growth in top CEO compensation is steadily outpacing the average Canadian's salary. According to the Centre for Public Policy Alternatives<sup>2</sup>, Canada's top 50 CEOs went from earning 85 times that of the average Canadian in 1995 to 235 times that of an average Canadian in 2011. Expressed another way, it takes until January 2<sup>nd</sup> of each year for the top 100 CEOs in Canada to earn the annual income of an average Canadian.

In the United States, the contrast is even more evident. A 2007 article of The Institute for Policy Studies/United for a Fair Economy (IPS/UFE)<sup>3</sup> cites an Associated Press survey of 386 Fortune 500 companies that found these CEOs earned the equivalent of 364 times the pay of an average American worker. And, according to IPS/UFE, it is estimated that the top 20 leaders of private equity and hedge funds a few years ago made more than average worker annual pay every 10 minutes.

There are no Canadian health executives in the public health system who receive this kind of stratospheric income nor do any rank among Canada's top paid CEOs. All of this does however raise an ethical question of how a CEO's contribution is valued. As a society we implicitly compare and establish worth through compensation. We make judgments on the net value of a masterful healthcare leader, an inspired entrepreneur, an all-star hockey player, or a gifted physician. Is there an ethic associated with this?

Although it is clear the top earning health executives in the public system do not come close to those in the corporate sector, in relative terms, health employees are still well compensated. The Canadian Centre for Policy Alternatives<sup>4</sup> January, 2012 report classifies those who earn a minimum of \$169,300 as being within the top 1% of Canadian income earners. This elite group includes a large number of health employees, including nurses and other health professionals, as is demonstrated in Ontario's 177 page 2011 disclosure report for Hospitals and Boards of Public Health document which lists earners above \$100,000<sup>5</sup>. In fact, disclosure reports do provide a transparency around compensation levels which is important in a fair compensation system.

Although it is noteworthy that there is only one female among Canada's top 100 CEOs, it now appears that the "glass ceiling" has cracked, if not shattered, when it comes to female CEOs in the Canadian public sector. Women are firmly installed at the helm of many of Canada's top health and post-secondary educational institutions and our anecdotal sense is that this trend is accelerating. As further evidence about growing gender diversity in the public service, there are currently six female provincial premiers in Canada, presiding over an estimated 85% of Canada's population.

Another dimension to health executive compensation is the interprovincial variation in CEO compensation across Canada. Although there are significant structural differences in how the provincial systems are designed and operated as well as other differences that make it a challenge to easily compare apples with apples, there is little doubt that relative CEO compensation varies widely across Canada. Whether these variations stem from each province's own reasons, including how to best manage accountability for public funds, affordability, or other factors, the principle of equal pay for work of equal value would seem to be in question across the country at the CEO level.

Indeed, the November 2011 Manley Report<sup>6</sup> was established to examine and provide recommendations on appropriate executive compensation policy for the range of hospitals in Ontario, in part as the result of variation in compensation policy and practice within the province. The report's eight recommendations outline ways to create a framework that standardizes compensation and provides a more rational basis for decision making. It is noteworthy that the report uses the 25<sup>th</sup> percentile of equivalent corporate organizations as a guideline for Health CEO compensation.

## **A NATIONAL FRAMEWORK**

An ethical question here is that with the increasingly challenging demographics pointing to a workforce shortfall in all disciplines, Canada needs to be able to compete to attract and recruit top talent who would seek out healthcare as a viable career option against a myriad of other

choices. So health executive compensation appropriateness is important. A significant variation in provincial compensation risks net migration of top talent from one province to another. In a national health system that uses national standards such as Accreditation Canada, and Canadian Institute for Health Information to measure outcomes and productivity, it is perhaps surprising that there are no national standards of compensation as well. Although the Manley Report falls short of making recommendations for a national compensation system, might this be an impetus for provincial counterparts to follow?

In a system where provinces strongly guard their jurisdictional rights, the development of any national framework can be challenging. No one province can tell another who it should hire or what it should pay within the health system. Even if a framework was agreed upon, it would be largely voluntary and difficult to enforce. We would argue, however, that such a framework remains a worthwhile objective. It could help meet the policy objectives of all provinces in trying to control the escalation of health costs; the largest part of which is the cost of labour. It would also add strength to the openness and transparency of compensation on a much larger playing field. There are organizations such as the Canadian College of Health Leaders who could champion such a framework. National collaboration and cooperation is important for a variety of health human resource issues and compensation could be included. A forum such as the Premiers' Health Care Innovation Working Group is one place where such discussions—and even decisions—could occur on a truly pan-Canadian basis.

## **ETHICAL PITFALLS**

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Finally, there are several particularly sensitive areas of compensation that are of special interest and fall under intense public scrutiny. Such issues that appear from time to time in the media can damage the reputation of both the organization and the executive associated with the issue. Prime examples include overly generous use of expense accounts, acceptance of gifts, kickbacks, conflicts of interest, and large severance packages that focus on the size of the anticipated value of future earnings of the executive. These events can generate considerable negative public opinion and warrant careful policy and vigilant awareness of the potential pitfalls by boards, the human resources team, and the executives themselves.

## **COMPENSATION THEORY**

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There are numerous business and human resource texts and articles that deal with aspects of compensation theory. They seek to address issues around the behavioural effects of different compensation approaches on both employees and employers. Some provide empirical research on the effects of different pay structure within organizations. Others focus on the links between

individual personality types, motivation, and pay-for-performance plans. Most recognize that differences exist between the economic and psychological aspects of pay. A sound understanding of compensation theory would no doubt assist an organization as it develops a comprehensive pay strategy. We are not aware of the application of formal compensation theory specifically to the Canadian healthcare context; however, such an application would be welcome. It could help inform debate and focus discussion around best practices in compensation, what works and what does not.

## **COMPENSATION POLICY REFORM**

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Policy makers and Boards of Governors in both Canada and the US are grappling with compensation reform. In Canada, The Manley Report is a good example of work to begin this process and at the same time reduce the risks of ethically unacceptable outcomes. In the United States, these concerns are intense especially within the financial sector leadership who have been blamed for the economic fallout, and for manipulating a flawed compensation system that did not provide a disincentive to enable them to receive huge returns well beyond what the average American could ever earn—even when they fail. As pointed out in the 2010 Ethics Resource Centre document<sup>7</sup>, “Certainly addressing specific flaws in compensation plans is critical and identifying the best metrics for measuring performance is part of the answer. But we believe establishing an ethical organization is a critical first step that sets the stage for executive compensation plans.”

It is likely that politicians and decision makers will increasingly weigh in on matters of executive compensation in the health sector. British Columbia and Saskatchewan have had Ministry imposed guidelines for a number of years. The minority Liberal government in Ontario recently indicated a desire to cap the pay of public sector executives at twice the premier's salary—no more than \$418,000 a year—and to scrap bonus pay for 2 years<sup>8</sup>. Such interventions are perhaps more likely where there is not a clear and reasonable compensation framework in place.

## **KEY ELEMENTS OF AN ETHICAL EXECUTIVE COMPENSATION PLAN**

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Perhaps the most important element of any plan is transparency. All elements of the plan and its administration need to be understandable and clearly disclosed. A good plan should include—and disclose—at least the following elements:

- (1) The basis upon which appropriate compensation is determined. What are the comparators or benchmarks being used?
- (2) Who determines the initial compensation for executives and what is their discretion in doing so?

- (3) What are the components of total compensation?
- (4) Is there a pay-for-performance or pay-at-risk component involved? What are the measures that determine how much incentive pay an executive will actually receive? Do the measures clearly incent the desired executive behaviour and avoid “perverse incentives”?
- (5) How are periodic or annual adjustments considered and applied? This can relate to economic adjustments as well as performance adjustments within an approved salary range.
- (6) Who reviews the overall executive compensation package, how often, and using what criteria?
- (7) What are the public disclosure and reporting requirements/commitments?
- (8) Is there an independent review or audit of actual compensation provided to executives? When and by whom?

## SUMMARY

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The issues around executive compensation in healthcare are complex. What is “fair” or “ethical” is quite subjective and may be viewed differently by different people. Consensus on the “right” number for any position is likely to be elusive. The heightened public and media interest we have witnessed on the subject is likely only to increase in the future. More scrutiny will invite an increased intervention by elected officials and decision makers. A reasonable, comprehensive, and fully transparent

compensation framework is an important stewardship obligation to taxpayers in the public sector. It is also a proactive response to future interest and scrutiny. We have argued that taking a more national approach to such a framework would add further credibility and have other workforce benefits. Ensuring that the health sector is able to retain and attract quality leaders requires a compensation program that is generally seen to be both fair and ethical, in its formulation and its application. It is a challenging but important objective for governors and leaders of the health system to pursue.

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