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Anticipating the Effects of Tariffs on Executive Compensation



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It seems every year as of late has presented some novel unknown for boards to contend with, and those unknowns almost always have a significant impact on executive compensation planning. This year is no exception as a new administration takes control in Washington. Of immediate concern to boards is the shadow of tariffs looming heavily over incentive plan goal-setting and performance assessment.

When it comes to economic uncertainties, the recommended courses of action relative to executive compensation are becoming standard and will apply following new tariffs. These actions include widening performance ranges; establishing the target as a range within the range; creating ex-ante agreements to exclude or adjust results for particular unknowns; using relative performance assessments for profit and growth metrics, as is done for total shareholder return; and employing good, old-fashioned ex post discretion. But before we consider which, if any, of these ideas should be embraced by the compensation committee in reaction to the current situation, it is helpful to acknowledge the following traits about the tariff challenge that make it unique.

1. Tariffs are a “known unknown.” We have known with near certainty for a year that if President Donald J. Trump returned to the White House, tariffs would be an issue. What has been and remains unknown is the economic impact of tariffs as we do not know all the countries and products that will ultimately be targeted, or for how long. We also do not know how each targeted country will respond. There are also likely to be significant second- and third-order knock-on effects that will severely complicate the predictive powers of compensation committees to lock in the right incentive plan treatment. Therefore, the “known” dimension argues for establishing ex ante treatment of tariff impacts, while the “unknown” dimension suggests that doing so is almost impossible.
2. Tariffs are a highly charged domestic political item. Tariffs are not an uncontrollable global phenomenon; they are a policy position. Stakeholders may have disparate views, but those views are likely to be very strong one way or another and could heavily influence corporate reactions to the policy implications.

3. Tariffs will have disparate impacts across industries, with some winners and some losers. For example, steel companies may benefit, at least, on a first-order basis, but automobile manufacturers and their suppliers may be in for a bumpy ride. Furthermore, retaliation by impacted countries, such as Canada's threat against "red-state" industries, may be quite narrow and targeted, possibly boosting the fortunes of nontarget industries (especially those representing consumer substitutes to those targeted).

Considering this context, the challenge facing compensation committees is far more complex than simple commodity prices or interest rate volatility. It even appears more daunting than the COVID-19 pandemic in 2020, when broad discretion and latitude was granted to boards to "do the right and fair thing." Indeed, the political dimension and the likelihood that middle- and working-class people may bear the brunt of economic dislocations through price spikes and possibly layoffs could put boards in the spotlight for "protecting" highly paid executives.

Returning to the tactics outlined earlier, it seems that technical fixes, such as range-widening, use of relative performance, and employment of ex ante calculation rules, offer very limited assurances of fairly addressing the concern, while at the same time potentially diminishing the incentive purpose of the plans, including by flattening the performance curve and insulating management from mitigation responsibilities. On the other hand, relying on ex post discretion presents its own problems, from asymmetrical expectations of management and the board to future disclosure of potentially significant adjustments to otherwise formulaic outcomes. However, these concerns can be addressed.

The differing expectations and assumptions of management and the board can be reduced through robust and ongoing boardroom discussions focused on understanding company-specific exposures, mitigation paths, and changes to the situation throughout the year. The board can make clear the boundaries of its potential discretion in real time, taking into account a changing business landscape and overall firm performance. As for future disclosures, the conventional rules apply: Think about, or even draft, your narrative throughout the year as potential acts of discretion are contemplated. Err on the side of transparency, including by sharing the objectives and considerations given regarding adjustments to incentive outcomes.

In some ways, tariffs are just the latest uncertainty that compensation committees must deal with. But they are also a unique issue, given the political dimension and the likely disparate impacts they will have across industries and demographics. Compensation committees would be wise to consider the use of traditional tools for addressing uncertainty while bearing in mind that without a crystal ball, old-fashioned ex post discretion may be indispensable.

About the Author

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About Pearl Meyer

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