Policy Update

Are CEOs Paid Too Much?

BY DAVID VAN DEN BERG

In June, President Obama announced the appointment of a Washington attorney as the administration's new "special master" for executive compensation. Kenneth Feinberg, the appointee, will oversee pay packages of company executives whose firms are receiving government assistance.

Feinberg will review and approve any compensation for the senior executives and the next 20 highest-paid employees at seven firms who received money through the Federal Government's TARP program. Those companies include Bank of America, Citigroup, AIG, General Motors, GMAC, Chrysler, and Chrysler Financial, according to the Treasury Department. Feinberg's duties also include advising 80 more financial companies that received government money about executive pay.

Part of the debate in Washington about executive pay has centered on the question of whether CEOs are overpaid relative to their contribution to firm value. Another question has revolved around whether their compensation packages create incentives for them to take excessive risks.

Across the corporate sector, the size of executive compensation packages has soared. The gap between the salaries of the workers and the CEO of a corporation has widened considerably. In 1994, the ratio of median CEO pay to median production worker pay was 90 to 1, according to a Congressional Research Service report. In 2005, that ratio had increased to 179 to 1.

Executive compensation packages often contain multiple elements. CEOs can receive company stock, stock options, deferred compensation, long-term bonuses, and nonmonetary perks. Not all of these are new. Stock options have been an important element of CEO pay since the 1950s, although executives receive those more frequently now.

In a 2008 paper, New York University economists Xavier Gabaix and Augustin Landier write: "[T]he sixfold increase of U.S. CEO pay between 1980 and 2003 can be fully attributed to the sixfold increase in market capitalization of large companies during that period." Gabaix says that this suggests the market for CEOs works well and there are only a few egregious examples of executives getting paid more than you would expect based on their contributions to a company's success.

CEOs may operate in a kind of superstar market, which the late University of Chicago labor economist Sherwin Rosen describes as one in which "relatively small numbers of people earn enormous amounts of money and dominate the activities in which they engage." The differences in talent levels among top executives is quite small, Gabaix and Landier argue. However, those small differences can lead to big gaps in compensation and are magnified by firm size. In their paper, they note that the first CEO on the list earns over 500 percent more than the 250th ranked executive.

The more-talented CEOs seem to add more value to their companies than the less-talented ones. Marko Tervio of the University of California at Berkeley tried to determine what would happen if the managers of the 1,000 largest U.S companies in 2004 had been replaced by less-skilled executives, such as the CEO of the company at the bottom of the list. The combined market value of the top firms would have been perhaps $25 billion lower. Tervio's calculations imply talented CEOs contributed $17 million to $21 million, or 15 percent of the total market value, of the largest 1,000 firms, writes Arantxa Jarque in a 2008 paper for the Richmond Fed's *Economic Quarterly*.

Economists differ on how closely the executive's pay should be linked to the company's performance. For instance, stock options may prove problematic in CEO compensation packages, Gabaix says, by encouraging excessive risk taking that only temporarily bolsters a firm's share price. In addition, a large decline in share price can render the stock options worthless and granting new options or re-pricing existing ones may seem to reward an executive for failure.

Part of the CEO's compensation should not be subject to risk, providing some insurance against bad performance due to factors outside of his control, Jarque writes. Failure to provide that assurance would make it difficult to recruit executives.

In a May 2009 paper, Gabaix and three co-authors propose one possible solution for improving incentive structures. They suggest awarding executive pay through "dynamic incentive accounts." Under the plan, CEOs would see their pay escrowed each year and would have no immediate access to most of it. A constant percentage of the executive's pay would be invested in company stock and the remainder in cash. The portfolio would be continuously rebalanced so that the portion of company stock is sufficient to induce effort at minimum risk to the executive. The executive would receive small portions of the account gradually, and that gradual vesting would continue even after an executive's departure. This could discourage an executive from behaving badly, such as using accounting tricks to inflate the company's short-run stock price before cashing out and leaving the firm in shambles.

In the end, structuring executive compensation in a way that aligns the incentives of the CEO with those of the company and its shareholders can be a tricky task — but one crucial to well-functioning markets. **RF**