Are U.S. CEOs Overpaid?


**NO:** Ira T. Kay and Steven E. Rushbrook, from “The U.S. Executive Pay Model: Smart Business or Senseless Greed?” WorkatWork Journal (First Quarter, 2001)

**ISSUE SUMMARY**

**YES:** Lisa Newton believes that the typical U.S. CEO should not receive ten or more times the annual pay of CEOs in other industrial countries. She also points out, in no uncertain terms, that CEOs are only partly responsible for the ultimate success of their organization and the accompanying increase in shareholder wealth.

**NO:** Ira Kay and Steven Rushbrook believe that U.S. CEOs are entitled to whatever levels of pay they receive. They argue from a free-market perspective where labor, like every other business input, is subject to free-market forces. They also provide a discussion on the incredible amount of wealth U.S. CEOs have created for their shareholders.

Over the last 15 years or so, it has become a spring ritual as nearly anticipated in some circles as the first pitch of the new baseball season. Business magazines and newspapers across the country, in blazing titles written to arouse reader antipathy, report on the incredible pay received by chief executive officers (CEOs) in the previous year at some of the nation’s largest corporations. Often, the articles include photos with a prominently displayed figure—the number of employees laid off the previous year by these apparently shameless and greedy CEOs! The intent of such prejudicial headlines is, obviously, to sell copy by painting CEOs as gluttonous fat cats and thereby appealing to the consumer’s sense of fairness. But beyond the legitimate economic objective of generating revenues, articles of this sort raise an important question for corporate America: On the whole, are U.S. CEOs overpaid? For many individuals whose sole exposure to this topic comes through popular media publications and news outlets, the answer is obviously “yes.” But, like most things in life, there are two sides to this story. In academic circles and corporate boardrooms across the country, there is much passionate debate on CEO pay with plenty of advocates on both sides. So, by way of introduction, let us consider a few points on each side of the question.

Those who argue that U.S. CEOs are overpaid raise several interesting points in support of their position. One of their most powerful arguments appeals to the apparent unfairness of paying a CEO tens of millions of dollars while the corporation is simultaneously laying off hundreds or even thousands of employees. Why should a CEO be rewarded for cutting the workforce? Related to this is the fact that some boards of directors have shown a willingness to award large bonuses not just to high-performing CEOs but also to CEOs whose organizations were clear underperformers the previous year. Such actions suggest that a CEO’s pay may not be tied to how well he or she performs, a situation that most would agree is not fair. Perhaps the strongest argument put forth by those who think U.S. CEOs are overpaid is based on a comparison of the CEO pay-to-worker pay ratio in America to that of other industrialized countries. Critics frequently point out that U.S. executives typically make several hundred times more in annual income than the lowest paid employees in their firms. In other countries, however, the ratio is considerably smaller. In Japan, for example, the typical CEO makes only about 15 times the lowest worker, and many member countries of the European Union restrict top executive pay to around 20 times the lowest worker’s pay.

On the other side of the debate, defenders of current U.S. CEO pay point out that CEO pay is, like most jobs in America, subject to labor market influences. Currently, the market for quality CEOs is very tight, and wage-increasing bidding wars are the norm. Thus, CEO pay is clearly subject to labor market conditions. In response to the layoff issue, proponents of existing CEO pay levels argue that CEOs are paid to make and execute difficult decisions. They point out that often the alternative to downsizing and staying in business is laying off no one and going out of business entirely. Another reason that U.S. CEOs deserve their pay is because of the credible amount of wealth created by their organizations over the last two decades. When compared to how much wealth CEOs have made for their shareholders, their pay levels look very reasonable.

The two articles that follow address the issue of whether or not U.S. CEOs, as a group, are overpaid. Lisa H. Newton argues that they are overpaid. In so doing, she raises and addresses several of the points made above. As you read her article, ask yourself whether you find her position convincing, particularly the last section where she argues that high CEO pay is against the public interest. The “no” article was written by Ira T. Kay and Steven E. Rushbrook. Their article covers all the points typically espoused by CEO pay advocates and throws in a few more for good measure. Particularly noteworthy is their discussion on the amount of wealth created by American CEOs over the last 20 years. Do you find this point to be particularly influential in the debate?
The Care and Feeding of the Truly Greedy: CEO Salaries in World Perspective

In 1996, Jack Welch, CEO of General Electric, received $21.4 million in salary and performance bonuses (and about $18 million in stock options); Lawrence Coss of the Green Tree Financial Corporation received $102.4 million in salary and bonus (plus stock options worth at least $38 million). Michael Eisner of Disney added $196 million in stock to his previous holding, somewhere around a third of a billion. The list goes on: Intel's Andrew Grove took home $97.6 million, Traveler's Group Sanford Weill made $94.2 million, and Citicorp's John Reed got $43.6 million. (These figures from John Cassidy's piece, aptly titled "Gimme," in The New Yorker of April 21, 1997; See also "The Top Ten List" in The Nation, December 8, 1997.) According to a preliminary study of 60 companies by Pearl Meyer & Partners, the CEO of a multibillion-dollar company received an average of $4.37 million in compensation in 1995. That was a 23% increase from 1994. (That number from an anonymous squib, "Checking in on the CEO's Pay," in HR Focus, May 1996, p. 15.) As Cassidy points out, we're not supposed to think those figures excessive:

But, according to Business Week, when you add together salary, bonuses, and options the typical C.E.O. at a large company saw his pay envelope grow by just fifty-four per cent—barely eighteen times the increase necessary to keep pace with the cost of living. (All told, his paycheck was only two hundred and nine times as big as the average factory employee's.)

Meanwhile, World Resource Institute figures from a few years earlier show that average annual compensation for a citizen (or Gross Domestic Product per capita, which is as close to the same thing as we can get in largely non-cash economies), in U.S. dollars, was less than $100 in Mozambique and Tanzania, less than $200 in seven other African countries (Burundi, Chad, Malawi, Rwanda, Sierra Leone, Somalia, Uganda), plus Nepal and Vietnam, under $300 in another 15 countries worldwide. (That list from World Resources 1996-1997, published by the World Resources Institute, p. 166.) We are not living in a rich world. But some CEO's are rich, very rich.

How, the untaught observer might ask, is this kind of disparity justified? How can it be that one of the world's inhabitants has a yearly compensation equal to the combined resources of 43,700 other of the world's inhabitants? We can understand that some people are lucky (born with perfect pitch) and others are not (born without arms). But the agreement to compensate an executive to the tune of tens of millions is not a matter of luck. It's a human decision if ever there was one. What on earth could make it the right human decision?

Justifications abound. Justifications are products, and like all products, are for sale for a fair market price. They are not always necessary or desirable, but become so very quickly if something not quite right—something that just doesn't smell very good—is happening. Having an annual compensation 209 times that of your employees, and 43,700 times that of fellow humans across the world, is one of those conditions that assaults the nostrils, so CEO's need justifications; and with that much money to spend, there's bound to be some left after the mortgage and the groceries to splurge on a justification or two. It's a perfect free market situation: a willing buyer (the CEO and his loyal staff) meets a willing seller (a well-educated and articulate wordsmith who really needs money), and a justification changes hands. A rudimentary knowledge of human psychology tells you that the wordsmith will instantly convince himself (or herself: this is an equal opportunity sellout) that CEO's are really are worth the enormous amount of money they're getting, and that the CEO will instantly convince himself (never herself: equal opportunity has not yet reached this level) that the justification is sound. But it isn't. As we might expect of products turned out at such speed in such an uncritical market, the quality isn't the best. It might be worthwhile to count some of the errors.

It won't do, for instance, to claim that the CEO contributes 43,700 times as much value to the world as the shepherd in Tanzania or the farmer in Chad. Even if the movies, or software, or candy bars produced by the CEO's company are really worth that many times the wool or corn produced by the Africans, they are not made by the CEO, who never goes near the production floor, but by the minions of the company, making 1/209 their CEO's annual pay. Whatever value the company produces, in short, could equally well be produced with a CEO making half that annual compensation, or, most likely, no CEO at all. (That suggestion might be worth examining.)

Nor will it do to claim that a company simply has to pay that much for such rare talent, that you really can't get a good CEO these days for under that price, given all the competition. The reason why that rings somehow false is that these decisions are made by the Board of Directors of the company, being a very small club of similarly compensated executives (on whose Boards of Directors the CEO will also sit), and the whole decision stays within that little overpaid group. One wonders if, given another Search Committee, someone could not have been found to do the job for, say, $2,000,000 per annum. Or maybe $650,000, which will pay most of the bills that a CEO might run up in the course of a year.

Comparisons with other high-paid talent also ring false. Entertainers, to be sure, make big bucks, singing or acting or shooting baskets. But here we have direct value for money, paid by those who are entertained. The entertainers
The Corporation From Cradle to Grave

How does the corporation get started? An investor, or a group of investors, decide that there is a good market for a good or service (i.e. a high demand coupled with the money to buy that which will fill the demand), and that the revenue from sales will exceed the cost of making the good or service available by a healthy margin (i.e. they're going to make a lot of money), so they buy the machinery and supplies and office space and talent required for the production of this good or service, and the production and marketing and advertising begin. In a magic metaphorical moment the articles of incorporation are signed, and a bouncing baby company is launched. Pretty soon the money's rolling in and the investors are very happy.

Now, it's always possible for one of these investors to decide he wants his money back, possibly to invest in some other enterprise; he can try to sell out his share in the enterprise, to one of the other investors or to a stranger. He may have problems doing that if the enterprise is not doing well or if he owns a very large share. To make a long story very short, that problem and myriad others were solved by a common Stock Market where all such shares can be bought and sold. In the present day, if an investor decides he no longer wants to be a shareholder, an investor, in Acme Corporation, he can sell his shares on the open market and invest instead in Beter Corporation. His choice.

Why would a shareholder want to sell out? The reason he bought in was to make money, and the company he set up is doing fine. If he wants continuing income, he'd better to hang on to the stock and continue collecting dividends. But suppose he just wants lots of cash right now: fine, he sells his shares, "liquidates" his share of the assets of the company, and he gets the cash. Now of course, if all the original investors early in the company's history decided to do that at once, the whole company would be liquidated. But that's not likely to happen. (In the contemporary stock market, it's almost impossible, just because of the huge volume of stock traded; some mutual funds turn over their entire portfolio in the course of the year, and stray stocks are likely to be picked up.)

Why is it not likely to happen, at least in the original model of sharehership? Because a funny thing happens when you put your money into a company as an investor. You begin to think of the company as "yours," which is appropriate, because it is, in part. You become anxious for its fortunes, not only for the monetary value of your initial investment, but for its own sake, as you would be anxious for the fortunes of a nephew. You watch its coverage in the press, cheering when it is favorable, grousing when it is not. You get attached to the company. You don't call your broker and have him sell it if it goes down a few points. For one thing, by the time you got hold of your broker and he got the stock offer for sale, the whole situation would have changed; for another, his fee would wipe out any gains; but for a third, your sense of ownership has become tinged with loyalty: you don't "sell out" until something really big, college or retirement or a new house, comes along. Besides, the individual shareholder is important in the company. If you are the owner of the company, even a part owner, you are the "principal," and all the company's employees are your "agents"---they act for you and for your interests. The CEO has to please you or (in theory: it almost never happened) you can wage a proxy fight at the annual meeting, bring about the election of your own Board of Directors, and have them hire a new CEO who will represent your interests more perfectly. So the CEO wants to keep you happy. But what does the CEO of your company have to do to please you? Not much: keep the company on an even keel, no scandals, distribute profits regularly, but remember to keep some of those profits to reinvest for the long term, because the long term is what you're in for.

That was the American shareholder up into the 1960s. There were mutual funds, of course, that owned stock, effectively pooling the investment funds of small shareholders to give them a diversified portfolio. Mutual funds did not operate like individual shareholders, for their managers, under the same fiduciary obligation to their shareholders, were not permitted to get attached to the companies they held---their job was to increase the total amount of stock value in the fund, and they didn't care what companies they had to hold shares in, in order to do that. But the funds were not really big players at the time.

They could become big players if they were joined by the vast money salted away in huge trust funds---pension funds and the like, and the endowments of not-for-profit institutions of all kinds. But these funds always invested in bonds, for the sake of safety; they didn't buy stocks. Until the 1960's, that is. Then these huge funds decided that 1929 was a long time ago, that stocks were quite as safe as bonds, and that it was time to trade in credit for ownership. Slowly they moved into the market, and took it over.

Again: what a fund manager wants from the investments he makes is rapid growth, the swift increase in the total amount of money in the fund. If it is a pension fund, that money is what the workers are going to retire on, and he (or she) works for the workers. If the fund is an investment pool, the manager works for the investors; if it is the endowment fund of a University, the manager works for the University. He will keep his huge funds invested in a company for the long term only if it is pouring money into his fund at a rate unmatched anywhere else in the market, or if he really has no choice. For a long time, the customs of the market and the available technology kept the funds' money moving slowly through the market, as well-weighted decisions moved the cash from blue chip to blue chip. But in the 1980's, the established ways of the market broke down, the white-shod country clubbers were shoved aside by the new breed of traders and arbitragers, and computer technology
advanced to the point of allowing program trading (programming your computer to make trades automatically, in a split second, in response to certain changes in the market) and otherwise very rapid shifts of money from one stock to another.

Then it all came together. The new breed of trader talked the managers of the huge slowmoving funds into becoming players in a new rapid-fire market, and their money funded the leveraged buyouts, the mergers and acquisitions, and the infamous hostile takeovers for which the 1980's became famous. In the process a new breed of fund manager was born, one who is acutely aware, first, that his fund (for instance, my favorite pension fund, CREF) owns very large chunks of (say) Acme Company, second, that the Acme Board of Directors had therefore better take CREF's interests seriously or he'll have them replaced (he may even demand, and get, his own Director on the Board), third, that his obligation is to increase the amount of money in CREF as rapidly as possible, fourth, that therefore the Acme Board of Directors must instruct the Acme CEO to run the company in such a way that CREF's stock position appreciates, and fifth, that if the CEO is unresponsive to that instruction, the Board must fire him and get a more responsive one. This is what we call an "active" investor: no longer does the fund manager simply sell Acme and buy Beter when Acme is not running the way he wants it to run. He gets in there and makes it do what he wants. (Oh, but doesn't CREF offer a "social responsibility" track, in which only stocks in socially responsible corporations are purchased, for conscientious investors? Yes indeed; and CREF's fund manager manages those funds just as aggressively as all the others.)

Once a CEO is on board who promises to extract money from the company's workings and move it into shareholder hands faster than ever, the Board kind of makes sure he doesn't forget what to do by structuring incentives to help his memory: the more the dividends flow and the price per share of the stock goes up, the greater his bonus.

That, of course, is the link between the new way of doing business and the CEO's compensation.

Now, what was on that memo? How does the CEO suddenly put lots more money into shareholder hands? We know that the size profit to be divided among the shareholders is based in part on the ratio of corporate revenue to corporate costs—best understood as a fraction with revenue as a numerator and costs as the denominator—so the CEO has to increase the numerator, the revenue stream, or cut costs, the denominator, or, preferably, both. Let me count the ways he might do that: (1) He can discover that the company's operations were rife with waste, inefficiency, theft, whatever; tighten it up, get things working the way they should, and the company saves oodles of money, squeezing down the denominator, without changing operations at all. He'll always say that's what he's doing, but it's unlikely that much savings will be got that way. (2) He can try to raise the numerator, the revenue, by raising price. In some markets he can get away with that for awhile, but in a highly competitive market that's just likely to reduce sales, theoretically to zero. (3) He can try to raise revenue by developing new products, new markets, or both. That's a good idea, but it requires more investment, therefore lower distributions of profits right now. CREF is not interested in waiting. It wants money now. (4) There aren't any other ways to raise revenue, so he has to cut costs. He can cut the paper clip budget and pick up cheaper raw materials for his manufacturing, and he'll do that, but it's not enough. The big item in any company is payrolls, not only for the meager salaries and wages the workers make, but also for those incredibly expensive medical and other insurance plans the company signed on for and now can't back out of. Fire a worker, and you save all that money. Fire (lay off) lots of workers, and you save lots of money. The denominator goes way down, raising profits, and the stock price goes way up. And that was the object of the expedition.

So that's what the memo was about. The CEO was setting the ball in motion to lay off thousands of workers. CREF will see the stock price go way up, and will be happy when the Board of Directors presents the CEO with a wonderful year-end bonus. That's why CEO compensation is so high, millions of dollars for successfully pink-slipping the company.

What does CREF do next? Sells the stock, obviously. After all, the prospects for the company are not good. They've cut way back on the quality of their materials, refused to reinvest in better plant or equipment, and laid off the folks who were doing the work, all to cut costs and send the price of the stock way up. In effect, they sold off some fraction of the value of the company, "liquidated" it, for quick cash, and distributed the cash. Now the company is worth a lot less, and CREF has no intention of holding on to worthless goods. Seeing the stock go up, investors who do not know why it went up will buy into Acme now on the expectation that it will go higher. CREF will take their cash and invest in the stock of (say) Beter, and promptly insist that Beter go through the same round of liquidation—cost-cutting, laying off, and neglecting reinvestment. Then Beter's stock will go up, CREF will sell it, and repeat the process. And all other funds are doing the same thing. In theory, the process could lead to the liquidation of the entirety of American industry. The grave of the productive corporation is already prepared; we await the death rattle. However long it takes, the CEO's will be well paid throughout.

In the Public Interest

What's wrong with very high CEO compensation? Two things: First, it is bad stewardship for people to take more than they can use, and unjust that some people should be making 43,700 times what other people make, especially when at least some of those other people are starving. John Locke, high priest of private property, put the case for the morality of private property very simply: each man may take from the commons (the world resources available to all) only as much as he can use, and only as long as enough and as good is left for others. The CEO fails on both counts.

Second, this compensation system is destroying American industry. It is commonplace by now that our cost-saving schemes have cost us the economy: our products made obsolete by foreign companies that invested in R & D [research and development] when we did not, and invested in new plants when we did not, our industrial jobs lost as our obsolete plants have to
be shuttered, as pink slips flutter from the corner offices in the most recent "downsizings" and "rightsizings," as the actual work is assigned to East Asian and Mexican factories and American workers are handed over to unemployment. We are moving, we are told, from an era of manufacturing to an era of information-driven service industries. These are precisely the industries for which the vast majority of the population is not prepared and from which they cannot profit. We are condemning a majority of working-age adults to temporary, underpaid, service jobs, while the tiny minority feeds off the global wealth generated by the exploitation of the rest of the world. The entire system is unjust, and cries out to heaven, and to an informed citizenry, for remedy. The compensation of the truly greedy might be a good place to start.

The U.S. Executive Pay Model

CEO pay has been under media scrutiny for more than 20 years, but the nature of that scrutiny has shifted recently. During the mid- to late-1980s, critics argued that compensation for CEOs and other executives was largely unrelated to the financial or stock market performance of their companies. These critics included the media, government, government agencies (e.g., Securities and Exchange Commission, Internal Revenue Service, Financial Accounting Standards Board), and institutional investors, including public employee pension funds.

During the mid-1990s, while some criticism was exaggerated, there was a marked move to strengthen the relationship between CEO pay and the stock price of their companies, primarily through increases in stock option grants and executive stock ownership. This pay/stock price linkage, combined with improved proxy disclosure and better governance by compensation committees, has played a role in motivating the increase in the value of the U.S. stock market.

Today the criticism continues, but the focus has again shifted. Executive pay has continued to rise dramatically along with the stock market. E-commerce, the Internet and technology sectors have created enormous wealth among founders and key employees. This new wealth has put significant pressure on boards to increase pay for their own CEOs, including those in the traditional economy. Critics contend that:

- CEOs are not worth their pay.
- CEO pay is too high in general.
- CEO pay is unrelated to performance.
- CEO pay went up because the stock market went up; the U.S. stock market would have performed just as well without stock options.
- CEO pay will not go down if the stock market goes down.
- CEO pay is part of a "winner-take-all" society.

This article will examine:

- Some of the reasons for record CEO pay levels
- The reasons that CEO performance is so vital to our economy

• The arguments for and against CEO worth
• When to measure CEO performance against pay
• The academic and author research relevant to this analysis
• A prognosis for the future.

Why CEO Pay Is So High

There is little doubt that executive pay has risen faster (10 to 15 percent annually) than average employee earnings (3 to 4 percent annually) and the rate of inflation (less than 3 percent annually). However, increases in CEO compensation packages should be kept in perspective. Arguably, three primary factors account for the rapid escalation of CEO pay packages:

1. A scarcity of CEO talent creates "bidding wars." Despite occasional performance failures, boards are willing to pay breathtaking sums to CEOs who can generate record financial performance. Clearly, the escalation of CEO packages is due in large part to the scarcity of proven CEO talent. Boards now are turning to outside candidates more frequently in search of talent to help them compete in an increasingly competitive global business community. The notion of promoting from within is being balanced by boards that need to globalize their operations and find proven talent quickly. Research has shown that the percentage of CEOs hired from the outside has risen dramatically in the past 10 years (nearly one in five). The high technology sector has exploded in the last two years, and the executive talent drain is apparent. Even with the NASDAQ market correction starting in early 2000, old-line companies continue to compete with high tech companies in search of scarce CEO talent. Subsequently, the equity packages offered by the high tech firms are escalating CEO packages at all companies even further.

2. The "winner take all" mentality is pervasive. The CEO and the senior executive team work under significant pressure and public scrutiny, and the most successful CEO candidates are often those who are able to assume extraordinarily high levels of risk and still win. In contrast to Japan and Germany, where senior executives function more often as a risk-sharing team, the typical U.S. model requires the CEO to assume the greatest risk and responsibility. It is certainly true that this model has worked successfully in the United States for at least the past 10 years. CEO pay packages often provide the counterbalance to the risk inherent in these positions, and boards are willing to pay such packages to a limited pool of candidates.

3. CEOs are compensated for making unpopular decisions. As CEOs become celebrities, unpopular decisions such as downsizing, mergers, and divestitures rest squarely on their shoulders. Increased media attention on the business community exacerbates this effect. In addition, large institutional shareholders often are quite vocal about CEO pay packages and company performance, and their actions exert significant control over a company's stock price. As a result, high CEO packages, in part, compensate for the stigma associated with the position.

Is CEO Performance Important?

The obvious answer is yes. High-performing CEOs are essential to the success of most companies. But the real answer is less obvious and has far-reaching social consequences beyond the executive suite.

Stronger Job Security and Better Career Opportunities for All Employees

CEOs who perform well are more likely to create and sustain successful companies and, in turn, employees are more likely to enjoy greater job security and better career opportunities. In the late 1980s and early 1990s, when downsizing was prevalent, employees who survived these waves of change were better positioned for the long term.

Today, while downsizing is less common, the pace of mergers and acquisitions has increased, and the U.S. economy has created a record number of jobs in the past decade. Successful CEOs, driven in large part by stock-based incentives, have created larger, more international companies serving a global customer base.

Stronger Retirement Security for Employees and Their Dependents

One aspect of higher CEO performance is an increase in the value of pension plan assets, thereby increasing the security of all pension plans. It is a great irony that public employee pension funds sometimes breed the most vocal opponents of pay-for-performance CEO plans because they, as well as state and local government employees, benefit so directly from the superior stock performance of Corporate America.

Over-funded pension plans, the result of higher stock values, allow companies to increase earnings per share (EPS). Increases in stock prices also contribute to portable retirement plans, such as the 401(k), allowing individual investment alternatives and mobility.

Are CEOs Worth It?

Spectacular headline CEO pay packages, especially in the e-commerce sector, have caused a flurry of media coverage. Obviously, that influences the general labor market for CEOs and executives, but it is not limited to them.

A study completed in the April 2000 issue of Forbes found 12 CEOs recruited within the prior 12 months from the traditional sector to the dot-com sector with packages valued at more than $100 million. Examples include Richard Braddock of Priceline and Margaret Whitman of eBay at more than $1 billion each. Are they worth it? Is this labor market "efficient"?

Because CEOs have alternatives, the labor market appears efficient. They could become consultants or venture capitalists or entrepreneurs, or go to another dot-com. Thus, the real question becomes, "What do you have to pay them to buy them out of their risk to go?"

For example, a well-known executive changes companies from one telecommunications company to another and he gets reimbursed first class airfare.
for his mother. Another high technology executive is given a $40 million jet with a tax gross-up to cover the jet's value.

On the other hand, the Wilshire 5000, one of the broadest market indices available, recorded total market capitalization at $15.8 trillion dollars for 2000, up 24 percent from 1999, and a 300-plus percent increase from 1995. In addition, according to the Crystal Report, aggregate total CEO pay went up 43 percent from 1995 to 1999, but the figure represented only a fraction of a percent (.3 percent) of the market capitalization for those companies. While the stock market has corrected in the last half of 2000, the crucial point remains: While CEOs are well paid, they have created enormous economic value.

During 1999, the Standard & Poor's (S&P) 500 Index yielded a 21 percent return, and the bull market span has extended nearly 20 years. Annualy, the S&P 500 Index has earned 19.9 percent (or 20 times) the original investment since August 1982. In addition, the Internet boom has pushed U.S. economic growth to record levels. Internet market capitalization represented well above 10 percent of the entire U.S. equity market at its peak. Internet companies also were responsible for more than 50 percent of stock market gains in 1999, as a result of 140 percent return and significant market weighting. In 1999, 257 Internet companies went public with a combined market capitalization of $242 billion. Even factoring in the correction of 2000, the returns remain quite remarkable.

Depending on how it is analyzed, the average large company CEO pay package is currently valued between $10 million and $20 million. The average increase was between 10 and 40 percent. But in sum, it still adds up to just 30 basis points—again, 3 percent of market capitalization for those companies.

Is mankind in the midst of a modern industrial revolution with all of the productivity and benefits to humanity? Or is it a decade of greed with people being paid what they really not worth? There is a sense of paradox. The question is, can theory or hypothesis explain it? In short, yes.

In economic terms, the fundamental question is "Are the best resources being allocated to their optimal use?" In effect, the labor market is saying that Margaret Whitman will add more to eBay, and to society, under Adam Smith's invisible hand, than she would at her former employer. Are the resources (executives, in this case) being put to optimal use?

The theory behind executive pay rests on the principle that CEOs are the agents of shareholders; they are separate from owners. Occasionally, this agent/owner gap creates a conflict of interest. Executive pay programs, especially stock ownership and stock options, are explicitly designed to close the gap and create alignment between CEOs and shareholders. This "agency theory" clearly states that CEO pay opportunity could help create an increase in performance.

When Do You Measure CEO Performance?
The most fundamental question is whether pay causes performance. To examine whether causation exists, an appropriate methodology and performance period should be chosen. Frequently, an inappropriate time period is chosen and hence, an erroneous conclusion is drawn.

The following two perspectives yield the most valid results:

- **Pay Opportunity vs. Subsequent Performance.** Current pay opportunity should be correlated with future performance. A high pay opportunity today (e.g., annual cash bonus opportunity or stock option grants) should cause a CEO to create future high performance for the organization. For example, examine the cash bonus opportunity three years ago and then consider performance in subsequent years.

- **Actual Pay vs. Prior Performance.** Current actual pay, such as cash bonuses or stock option profits, should be correlated with prior performance in the past several years. Often, in journal articles and media clips, attempts to correlate past pay-outs with subsequent performance, or current pay opportunities (e.g., stock option grants) with past performance (e.g., three-year total returns to shareholders) result in wholly inappropriate perspectives that mislead the audience.

To measure and assess pay for performance, two criteria should be considered: pay and stock ownership. Consider today's pay, plus "in-the-money" options, compared to total shareholder return (TSR) in the past five years. As for stock ownership, take the opposite perspective and consider past stock ownership with performance in the subsequent five years.

For example, consider Company A and Company B, each of which granted 1 million options to their CEOs at $20 each in 1998.

- Company A had a $15 stock price in 1996, a $20 stock price in 1998 and a $20 stock price in 2000. Its Black-Scholes present value was approximately 50 percent, or $10 million in 1998, and there were no other stock option grants.
- Company B had a stock price that went from $25 to $20 to $40. The Black-Scholes value also is $10 million. But in-the-money value is $20 million in 2000.

One method would be to consider the 1998 Black-Scholes value compared with the 1996 to 1998 TSR, which includes the increase in stock price plus dividends.

- Company A had $10 million in pay, and 33 percent TSR from 1996 to 1998; the stock price increased from $15 to $20.
- Company B had $10 million in Black-Scholes value, but the stock price fell $5 from $25 to $20, down 20 percent.

At first glance, it is assumed that no pay for performance exists because both companies had CEO pay of $10 million under this methodology, one with TSR of positive 33 percent and the other with a negative 20 percent TSR.

The alternative methodology is more appropriate because it considers the correct time period—actual pay in the year 2000 vs. TSR for the prior three years. For Company A, there is zero pay and zero TSR. For Company B, there is $20 million pay and 100 percent TSR. With this alternative, the conclusion is that there is pay for performance.
The answer depends completely on the methodology. A case could be made that the large option grant motivated Company B’s CEO to succeed, and while Company A did not succeed, there was no pay for that low performance.

**Academic Research**

The following six points categorize questions that most researchers seek to answer in relation to CEO pay:

1. Is there pay for performance? Is a CEO’s pay sensitive to company performance? Is there a correlation?
2. Does stock ownership matter? In other words, can companies ignore CEO stock ownership and grant stock options? If stock ownership is important, do stock ownership guidelines work? Do stock ownership guidelines create CEO ownership, which improves company performance?
3. Are there motivational differences between stock ownership and stock options? Are executives afraid to buy stock if the price is volatile? Do large stock option grants motivate expensive company stock repurchase programs?
4. Do stock options create ownership?
5. Are poor performing CEOs terminated?
6. Is the U.S. model being exported?

**According to Research Findings**

**Is There Pay for Performance?**

CEO pay, including stock, is highly sensitive to company performance. CEO compensation in Year 1 is positively correlated with corporate performance in Year 2, the appropriate measurement period.

This demonstration of the pay/performance link is particularly important in light of the criticism that CEOs receive high pay for superior performance, and receive high severance packages when poor performance leads to termination.

**Does CEO Stock Ownership Matter?**

CEO stock ownership has increased dramatically, and company performance is positively correlated with the percentage of stock held by managers. In addition, executive stock ownership guidelines improve company performance.

**Are There Motivational Differences Between Stock Ownership and Stock Options?**

Large stock option grants are correlated with increased stock price volatility, suggesting that CEOs who receive large stock option grants may subsequently cause stock price volatility. Companies with volatile stock prices have executives with less stock ownership, confirming that executives are reluctant to purchase highly volatile stock. Stock option grants, without stock ownership guidelines, may increase stock price volatility and reduce executive stock ownership levels. In addition, stock options are correlated with lower stock dividends and increased stock repurchase levels.

**Stock Dividends**

Because the current stock price is inversely related to the expected future stream of dividends, lower dividend payments to shareholders will likely result in higher future stock prices and therefore greater potential stock option gains.

**Company Stock Repurchases**

Companies are repurchasing shares at an unprecedented rate to fuel their stock option programs. To fund these repurchases, companies are either using cash or borrowing funds, increasing both their debt/equity ratios and their risk significantly, and reducing the risk adjusted value of their stock.

**Do Stock Options Create Ownership?**

Stock options do not create stock ownership but tend to serve as an imperfect proxy for stock ownership. Stock options can help, but they must be combined with executive stock ownership guidelines and vehicles to assist executives achieve the required ownership levels. Stock option gains, even those for e-billionaires, can evaporate quickly during an economic downturn.

One way to promote stock ownership is a management stock purchase plan, which allows executives to purchase discounted company stock with a portion of their cash bonus and/or salary. This plan has significant tax, accounting and financial planning advantages.

**Are Poor Performing CEOs Terminated?**

Several sources of academic literature indicate that poor performing CEOs are, in fact, terminated.

**Is the U.S. CEO Pay Model Being Exported?**

Yes, the U.S. CEO pay model is being exported, but with significantly less performance sensitivity than the U.S. models. For example, Germany, Japan, France and other nations are incorporating pay-for-performance plans, but on a more limited basis.

Comparisons of U.S. and overseas CEO pay packages are difficult given the vastly different size of the countries and companies. Because CEO pay tracks with company size, given the complexity and risk involved, the U.S. CEO pay packages are likely to be larger than those found overseas. In addition, international studies often do not account for differences in culture, local welfare benefits and tax rates.
CEO Pay Study 2000–2001

U.S. executive pay, especially CEO pay, continues to generate controversy, with some in the media believing that it has gone beyond appropriate limits. Others, including most institutional investors, believe that the way U.S. CEOs are paid is a source of significant competitive advantage.

Can America's Economic Success Be Attributed to CEO Pay-for-Performance?

While there are outliers—such as high paying companies with low performance, and low paying companies with high performance—on the average, there is a strong correlation between CEO pay and company performance. Having shown this correlation, causation is difficult to prove. Still, the greater the CEO's financial stake in a company, the more likely he/she is to act in the best interests of shareholders.

Is CEO Cash Compensation Sensitive to Market Performance?

Yes, in terms of total shareholder return (TSR), a CEO's total cash compensation is sensitive to a company's stock market performance. In a Watson Wyatt survey sample, CEOs with above-median change in total cash compensation (TCC, or base salary plus bonus cash bonus) correlated with an 18.8-percent five-year annualized TSR vs. 9.8 percent annualized TSR for CEOs with below-median change in TCC.

Does CEO Stock Ownership Correlate With Market Value?

An effective way to examine this issue is to first calculate Tobin's Q, the ratio of stock market valuation plus long-term debt divided by the replacement cost of the company's assets. This measure, developed by James Tobin of Yale University, is also known as intellectual capital, or the premium that the market is willing to pay for how well the company manages its assets (including human capital). Values above 1.0 imply that the market views the company as more valuable than the sum of its assets. Then, after examining CEO stock and the ratio of CEO ownership to CEO base salary, the Tobin's Q of companies with high CEO stock ownership proved to be 40 percent greater than that of companies with low CEO stock ownership. Evidently, the market is willing to pay a premium for companies with leaders who have aligned their interests with the shareholders'.

The New Millennium

Given the dramatic change in the past decade, predicting even the near future seems a daunting task. Based on client work and continuing research, the following should hold true in the next 10 years:

- Pay-for-performance plans will continue at the CEO and executive levels, and will spread deeper into organizations. Companies with broad-based stock plans will continue to significantly outperform those with narrow stock plan coverage.
- CEO total pay increases will level off as salary increases have done in the recent past. Many incentive plans may have already reached optimal leverage levels. Continued outcry by the media and public are likely to check pay excesses for the executive team in most cases.
- Individual investors and large institutional shareholders will resist further stock option overhang and expensive share repurchase programs that have fueled record stock option grant levels.
- Stock option overhang will level off in the 10 to 15 percent range for most industries, and at 20 to 25 percent for the high technology sector, including e-commerce. Push-back from investors, combined with sufficient incentive pay plan opportunities, has already started to level off overhang levels.
- Stock ownership levels, particularly for the CEO and the senior executive team, will continue to rise.
- European and Pacific Rim companies will emulate the U.S. executive pay model, including pay-for-performance and stock ownership. While overseas compensation professionals may view this as executive greed, most companies probably will tailor plans to suit their own cultures.
- Actual year-to-year CEO pay levels will fluctuate with stock market and economic performance indicators. While compensation opportunities, including stock options, will grow modestly, actual payouts are likely to decline if the stock market corrects further. Any future stock market correction will be smaller because of significant CEO stock ownership levels, which have provided the U.S. economy with a "cushion" of high performance.
- Pay programs at traditional companies and new economy companies will converge, with proven best practices being adopted by the majority.
- And finally, CEO pay will, of course, remain controversial.

Undoubtedly, U.S. companies are on the right track given the record financial performance of the past decade. Performance-based pay for CEOs, combined with programs that encourage stock ownership, should fuel steady job creation and financial success in the future.

The answer to the question of whether U.S. CEOs are overpaid depends on who answers. Clearly shareholders, including private investors and large institutional shareholders, would respond with a resounding "no." The record performance-based CEO pay packages are a small price to pay for unprecedented productivity and growth.

On the contrary, some would argue that the average worker should share in the success to a greater extent. As research indicates, including all employees in pay-for-performance and stock-based incentives should result in even higher levels of performance.
POSTSCRIPT

Are U.S. CEOs Overpaid?

So, how high are U.S. CEO salaries? In 2001, the average U.S. CEO annual income was $13 million (Business Week, April 16, 2001, pp. 77-108). While this figure may seem large, consider that it includes the extremely few—though highly publicized—cases of exorbitant CEO pay such as the $293 million, $164 million, and $157 million recently paid to the heads of Citigroup, AOL/Time Warner, and Cisco Systems, respectively. A few extreme cases such as these can easily skew the numbers, suggesting that there are many CEOs in America making considerably less than the $13 million average. Nevertheless, figures such as these beg the question: Are American CEOs overpaid?

You have just read two different answers to this question. Lisa Newton believes that the typical U.S. CEO should not receive ten or more times the annual pay of CEOs in other industrial countries. She also points out, in no uncertain terms, that CEOs are only partly responsible for the ultimate success of their organization and the concomitant increase in shareholder wealth. Further, she argues, no matter how much responsibility a CEO actually does carry, it isn’t enough to justify the levels of compensation currently being paid to top executives in America. She concludes her argument with an appeal to the reader’s emotions by declaring that it is immoral, in effect, for a CEO to “take” more than he/she can use, particularly “when people in the world are starving.” Despite its emotional appeal, one must be careful to embrace this last line of attack without considerable thought: After all, it has more than a little in common with the basic tenets and principles of communism.

Ira Kay and Steven Rushbrook believe that U.S. CEOs typically earn every nickel they make and are, therefore, entitled to whatever levels of pay they receive. Theirs is a free-market view—that labor, like every other business input, is subject to free-market forces. For the typical CEO, annual compensation accurately reflects his or her worth in the market. According to these authors, in this sense, U.S. CEO pay is both fair and equitable.

Suggested Readings


Louis Lavelle, CEO pay: The more things change... Business Week, October 6, 2000, pp. 106-108.

Kevin J. Murphy, Top executives are worth every nickel they get. Harvard Business Review, March/April 1986.