Growing Executive Compensation Levels: A Moral and Economic Justification

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To whom much is given, much is expected. While this biblical verse may not have been referring to corporate executives, it is certainly applicable to their situation. As the average market capitalization of American public companies continues to the rise, so too does the compensation package for these companies' Chief Executive Officers. Chief Executives at the highest level of the corporate ladder are richly rewarded for their responsibility; from 2000-2003 the average CEO was paid $8.5 million annually.[1] While the everyday worker may be appalled at such an exorbitant figure, this paper will argue that there is nothing inherently immoral about the fact that compensation levels are so high. The rising pay level for CEOs is justified by recent increases in overall national wealth and productivity, increases in competition for top-tier talent, and increases in overall job risk associated with the position. The nature of the self-correcting American market is such that CEOs earn their salary in a legal and moral fashion. The discrepancy between CEO pay and average pay is not only justified, but necessary to sustain current conditions of the American economy.

Milton Friedman argues the only responsibility of a business is to increase the value of the firm in order to increase shareholder profits.[2] To achieve this end, the interests of the CEO and the shareholder should be as closely aligned as possible. This way, the CEO's main priority is to increase his firm's share price. High pay that is tied to company performance is the simplest way to accomplish this goal. If the recent dramatic increases in compensation were simply increases in base pay, criticism might be well-founded. However, executive pay includes several additional types of compensation including annual bonuses tied to performance measures, stock grants, and stock options. In the early 1990s, stock options on average accounted for only 20% of a CEO's compensation package. In 2000, they accounted for 50%.[3] Prior to these changes, CEOs would take home the same large paycheck regardless of company performance. With more diverse compensation, they now have greater incentives to meet and exceed performance goals. If the stock price of the company falls below the contracted exercise price, this portion of the compensation package is rendered worthless. Therefore, the changes in compensation structure associated with increasing pay levels will help further the interests of the stockholders. This is one moral justification for why CEOs get paid so much more today than they did in previous years.

While the shareholder theory outlined above clearly justifies the shift to more diverse payment schemes for CEOs, it does not necessarily justify the absolute high level of pay. It is not indisputably clear that an increase in total compensation was necessary to convince CEOs to accept the shift in payment styles. Perhaps an alternative arrangement could have been made in which CEOs would accept stock options in exchange for, not in addition to, some of their current pay. This way, the interests of the executives and the shareholders would still be aligned, and shareholder earnings would not have to be reduced to cover the higher salary. CEOs would likely resist this offer, though, as options or stock grants add a greater amount of risk to their compensation "portfolio." Still, it is uncertain if CEOs would actually leave their jobs or consciously lower their job performance if the board of directors forced them to accept such a change.

Due to the uncertainty outlined above, one way to ensure consistency with Friedman's shareholder theory that company value is increased is to perform a cost-benefit analysis on a CEO's salary. Scholar Jeffrey Moriarty argues that if adding shareholder value is the inherent obligation of the firm, then the CEO should increase firm value in excess of his salary.[4] Therefore, in order to justify his salary, any marginal increase in the total market value of a company should outweigh the total marginal increase in a CEO's pay. While it is difficult to determine exactly how much value one individual can add to a company, the overall market capitalization of a company provides a telling indication of performance. From 1980 to 2003, there has been a six-fold increase in CEO pay along with a six-fold increase in weighted market capitalization.[5] Moriarty is quick to point out the rising trends in compensation in his "dessert" argument that CEOs do not earn their pay; however, he fails to mention this parallel rising trend in results.[6] Year-to-year increases in CEO pay are extremely consistent with shareholder gains.[7] The CEO is certainly not the only employee who contributes to exceptional performance. It is difficult to prove that the parallels between pay and results are causal in nature rather than merely correlated. However, the fact that higher costs are correlated with higher benefits makes CEO compensation appear to be morally acceptable since both CEOs and shareholders are better off.

In addition to the stakeholder theory argument, a utilitarian argument also supports CEO compensation. Higher compensation levels are justified to the extent that total social utility is maximized for anyone who either affects or is affected by the firm's actions. In order to support executive salaries, paying a CEO a higher salary would have to create an overall net increase in utility for the CEO, the employees, the customers, the shareholders, and others whose utility is at stake. As previously discussed, shareholders have benefited through rising stock prices. Higher stock prices also have the potential to benefit customers. They indicate that firms have greater access to capital, enabling them to invest in efficiency improvements and achieve economies of scale. As a result, consumer prices will likely decrease. Lower pries will stimulate demand, leading to benefits for distributors or manufacturers connected to the firm's product. Only the firm's employees do not necessarily benefit as the increase in company profit may not necessarily be used to increase their salaries.

In addition to his shareholder theory, Friedman's unrelenting support for open markets supports current levels of executive compensation. In an open market, there is only one legitimate way to value any service or commodity; it is "worth" whatever people are willing to pay for it. As long as there is no coercion involved, the free market puts a price tag on every commodity. While some may argue that a Lexus is not "worth" so much more than a Chevrolet, manufacturers should not be reprimanded for charging whatever the market will bear. Neither should CEOs. So long as legal regulations require full disclosure of corporate compensation, the shareholders will be able to freely evaluate whether the firm still provides value. If shareholders perceive that high CEO pay is compromising company profits, they will choose to either sell the stock or refrain from purchasing stock in the first place. This provides a check on CEO pay and ensures that they are leading their firms in a manner that makes everyone better off.

In addition to the participation of stockholders, the oversight of board members also justifies the elevated level of CEO compensation. Although some argue that CEO compensation is intentionally inflated by members of the board in order to increase their own future salary, it is unfair to presume that board members will act on self-interest alone. While evidence suggests that higher-paid board members grant their CEOs larger compensation packages, the high salaries of all participants may just stem from the fact that a company is larger, more profitable, or more risky. Conflicts of interest exist in many career fields. A car mechanic, if acting in his best interest, would always claim that a car needed a new engine or other expensive parts. However, just as a car mechanic would not want to put his reputation or the reputation of his industry at risk, neither would the board member.

The increasing presence of private equity firms further negates any claims that special relationships between the CEO and his board of directors are the main driver behind the inflation of CEO pay. Critics of high CEO pay argue that executive salaries are invalid because they are skewed by negotiations that are not at arm's length. Private equity transactions such as CEO salary agreements, however, are always at arm's length. Private equity operates on the idea that impartial bankers will cut out inefficiencies to add value. Employees are often fired and paychecks are often slashed. When private equity firms buy a company and "take it private", they will not hesitate to cut compensation for a CEO if she is not performing at a level judged to be commensurate with his or her salary. Therefore, a comparison of salaries in public and private firms would be telling. Sageworks, a stock research firm, compared the salaries of CEOs in ten public firms and their counterparts in ten private firms of the same size and industry.[8] There is indeed a discrepancy in CEO pay at private firms versus public firms, with salaries averaging at $3.3 million for the former and $7.7 million for the latter.[9] However, the difference in salary may be attributed to inherent differences in the nature of the job. CEOs of public companies must take on greater public scrutiny as well as greater legal liability, especially after the implementation of Sarbanes-Oxley. Also, CEOs of privately held companies get a more of their compensation in cash, while CEOs of public companies are compensated with more stock options or other performance-based alternatives. This is more risky, which entitles CEOs to demand greater overall pay in order to take on this risk.

A dramatic rise in the number of private equity firms also presents another justification for high compensation for CEOs: the competition for talent. CEOs are uniquely able to maneuver across industries. A doctor trained in neurosurgery could not suddenly decide to switch to ophthalmology just because a higher demand offered an increase in salary. However, a CEO trained in managing financial operations for a company specializing in one industry would have a much easier time transferring his skills to a vastly different industry. This is demonstrated by the relentless pursuit of CEOs by headhunters representing private equity firms. In 1987, private equity firms managed a cumulative total of $1 billion in assets. Today, over 2700 firms manage $500 billion in assets.[10] In recent years, CEOs from major companies such as General Electric and IBM have left their firms to pursue careers in private equity. Thus, in order to retain superior talent higher salaries must overshadow the allure of the private sector.

Arguments comparing the risk levels and downfalls of being employed as a public versus a private CEO can also be applied to being employed as a public CEO versus an everyday employee. CEOs are the face of the company and are held responsible for any major event gone wrong. They are subject to public scrutiny and greater liability. CEOs are often held accountable for difficult situations over which they had no control. For example, in 2007 Citigroup experienced losses from mortgage-backed securities. Even though many banks were in similar positions and CEO Charles Prince alone did not cause the subprime crisis, he was criticized for his performance and ultimately left the company. As mentioned before, however, CEOs do have greater job mobility than those in other fields. Nonetheless, even marketability of managerial skills often does not offset the hassle of seeking out a new position.

CEOs work longer hours on average, which necessitates higher pay to compensate for this sacrifice. Accepted economic models support the idea that as individuals move higher up the corporate ladder, they must be paid exponentially more if they are expected to increase the quantity and quality of labor that they produce. Current economic theory provides a model detailing the tradeoffs between labor and leisure. In this model, there are two battling effects. The substitution effect suggests that as a CEO's average wage rises, she will want to work more hours because the opportunity cost of leisure will be higher. However, the opposing income effect suggests that as a CEO becomes wealthier, marginal utility of money decreases. She will then be more likely to choose leisure over labor. Only a much higher salary would prevent one from making this choice.

Jeffrey Moriarty's "utility view" argues that if CEO salaries were lowered across-the-board, fears of a massive exodus of CEOs would be unfounded. CEOs would have no better alternatives given the concurrent elimination of alternatives. Although the talent pool may not be affected in the short term, there could be greater long term implications. High salaries of top businessmen may be necessary to encourage the finest students to enter the field. The earnings potential of jobs in is arguably one of the industry's strongest appeals. Among elementary school students, the answer to the question "what do you want to be when you grow up?" is usually not "a CEO". Managing arguably does not provide the same sense of contributing to the world or opportunities for personal expression as do professions in the medical field or the arts. As such, a high salary is one way to recruit top talent to a field where it takes many years to reach a position of power. The "tournament theory" suggests that by making lucrative salaries the prize for making it to the top, more competitors will enter the race.

Still, there are many others who have unpleasant jobs but commit to them in spite of lower salaries. Although the discrepancies in pay may therefore seem "unfair", this argument seems to center on gut reactions rather than thorough analysis. The initial shock at hearing that CEOs were paid 430 times the amount of the average American's salary in 2004 may be difficult to overcome. However, the math behind this statistic is highly questionable. A handful of high-paid outliers distort the data, making the median a more reliable figure. The median take-home pay for CEOs in 2004 was 187 times that of the median worker.[11] Another important clarification is the nature of the sample used to collect data. The figures mentioned are based on a survey of CEOs of S&P 500 companies, some of the largest and most successful companies in the world. A Towers Perrin study on a more complete sample concluded that the population compensation for CEOs hovers around 39 times that of the average worker.[12]

High CEO pay is justified in that it aligns CEO interest with company performance and thus shareholder incentives, is freely agreed upon and serves to adequately compensate for job demands and foregone opportunities. Arguments involving increased competition and incentives show that high payments are not only justified, but necessary to sustain the attraction of talented workers to CEO positions. Together, these ideas show that the reasoning behind high CEO compensation is legitimate and moral.

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