

Policy Analysis

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Routing

Executive Pay Regulation vs. Market Competition

by Ira T. Kay and Steven Van Putten

Executive Summary

The economic slowdown and the active political season are generating calls for imposing new regulations on executive pay. The presidential candidates of the two major parties have lashed out at what they perceive to be excessive pay for certain executives or for corporate executives in general.

Such populist sentiments are often based on misunderstandings about the role of corporate executives in the economy and the vigorous competition that exists for these highly skilled leaders. In the past, federal regulatory efforts based on such misunderstandings have generated unintended consequences, which have damaged the economy and hurt the ability of the market for executives to self-regulate over time.

The labor market for executives and the associated pay levels are already subject to high levels of regulation. Indeed, U.S. corporations are subject to more stringent executive pay disclosure requirements than corporations anywhere else in the world. Before additional regulatory and legislative efforts are unleashed, policymakers should examine the rationale for current pay structures and the strong links between executive

pay and corporate performance.

The misperceptions that drive regulatory efforts are grounded in the idea that the market for executives is not competitive and that pay levels do not reflect supply and demand for talent. Critics claim that executives essentially set their own pay through their influence over the boards of directors of corporations. This “myth of managerial power” leads some policymakers to conclude that greater government regulation is necessary because the market is “rigged.” However, a large body of empirical research documents that labor markets for executives are indeed competitive, and that pay levels track corporate performance.

This study examines the market forces that set the parameters of executive compensation, the process that boards use to determine pay packages, and the data that indicate the efficient workings of the current “pay-for-performance” model. It also discusses the adverse consequences of imposing rules and regulations on an executive compensation system that has helped to generate great wealth for shareholders and millions of jobs for American workers.

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The parameters for executive pay are determined by supply and demand, and incentive payouts for executives are generally determined by performance.

Overview of the Issues

The executive pay model widely used in the United States is essential to the success of U.S. corporations and continued growth in the economy. But this “pay-for-performance” model is now threatened by overregulation, which is driven by misperceptions about the labor market for executive talent. That is unfortunate, because the competitive system of executive pay has helped fuel business growth, which has generated wealth for shareholders and opportunities for corporate employees. Attempts to control the labor market for executives and reshape the pay levels it produces may undermine this successful system.

The success of the U.S. economy is closely connected to its unique approach to human capital. This approach is based on relatively unregulated labor markets, high labor mobility, and a century-long reliance on various forms of incentive pay. In general, labor markets in the United States are among the least regulated in the world.¹ Job candidates enter the market and compete with other candidates for the highest wages, while employers pay the wages required to recruit and retain talent and motivate performance. Supply and demand generally set the parameters for pay, without the government restricting how much employees can earn for the value they create.

The U.S. labor market for corporate executives is an important exception to the general U.S. policy of minimizing labor market regulation. Critics have argued that the labor market for executives does not reflect supply and demand for executive talent, and that executives essentially set their own pay through power over their boards of directors. Compliant human resources executives, compensation consultants, and board members bend to the will of the chief executive officer (CEO) in shaping executive pay packages. We refer to this view as the “myth of managerial power.”²

Productive discussions about the best methods of setting executive pay have been partly preempted by faulty assumptions about executive pay promoted in the popular

press and the business media. Media stories often portray a corporate America ruled by executive greed and excess.

Nevertheless, meaningful debates about executive compensation are taking place. In a recent Watson Wyatt survey of board members of major corporations and institutional investors, we found that board members believe that the pay-for-performance model directly contributes to improved corporate performance.³ By contrast, many institutional investors tend to view executive pay as excessive. Given these differences in how boards and investors assess executive pay, the two groups need to work together to continue refining pay structures. The important point is that executive pay structures evolve over time and are subject to ongoing reforms within a competitive market environment.

A Dynamic and Competitive Market

The parameters for executive pay are determined by supply and demand, and incentive payouts for executives are generally determined by performance. In the market for top corporate executives, companies search for and hire CEOs from an extremely small pool of people. Those people must be capable of managing large and complex organizations and be willing to risk a large portion of their pay on their ability to increase company value. Many executives are paid handsomely, but their pay reflects only a small share of the trillions of dollars of wealth they help to create for shareholders.

The labor market for CEOs is very competitive. They are hired and fired, and their pay goes up and down, commensurate with the performance of their companies. That conclusion is based on our own research and the results of many academic studies.⁴ But this reality of the competitive pay environment of America’s executives is at odds with the myth of managerial power.

Many examples show how executive pay-for-performance works, but let’s look first at stock options. Although stock options have become less popular recently, they remain the archetypal executive pay program and are still

Table 1
Company Returns and Profits on Stock Options

	Companies		Executive Profits on Stock Options		
	Number of Companies	One-Year Return (%), 2006	2005 \$millions	2006 \$millions	Change (%), 2005–2006
Companies Creating High Returns	544	28	6.6	10.8	63
Companies Creating Low Returns	544	-3	8.8	5.5	-38
All Companies	1,088	12	7.9	7.6	-4

Source: Watson Wyatt Worldwide data.

Notes: All numbers and percentages are medians, except for the number of companies. Returns refer to total shareholder returns (stock price appreciation plus dividends).

granted to thousands of CEOs. Table 1 reports our analysis of the relationship between the total return to shareholders generated by companies and the related stock option compensation for executives.⁵ A review of the largest 1,088 companies in the United States in 2006 shows that the higher-performing companies provided larger stock option profits to executives and the largest increase in stock option profits over the prior year. Thus, executives in companies that performed well were rewarded for that better performance.

As with most markets, outliers exist in the executive pay market. At some companies, the executive does not demonstrate exceptional performance and still receives substantial pay. Such outliers are often challenged by shareholders and called out in the press. But the market usually corrects itself, and such executives are commonly ousted for poor performance. The outliers push the boundaries of the system, but they spur self-regulation and reform.

Most economists and executive pay experts believe that the labor market for executive talent functions well. Supply and demand primarily determine the amount of compensation that executives receive, while other institutional factors, such as managerial power and the structure of corporate boards, play a minor and secondary role. Here is some of the evidence that the U.S. market for corporate executives is competitive and efficient:

- Executives always have the option to quit, and many do. One of the primary responsibilities of corporate boards is to ensure continuity of management. Boards know that if executives are underpaid, they can leave and gain higher pay elsewhere. The cost of a highly skilled executive quitting can be billions of dollars in market capitalization.
- Newly hired CEOs from outside are often paid much more than internal promotions. The managerial power argument cannot explain that differential.
- High-performing companies reward executives with higher “realizable” pay than low-performing companies, as we examine below.
- Market pressures work. In recent years, boards and executives have responded to market pressures by putting in more performance-based pay programs and reducing or eliminating non-performance-based programs, specifically severance, perquisites, and executive supplemental pensions.⁶
- Prior attempts to reduce pay through legislation and regulation have probably resulted in higher, not lower, pay for executives. Examples include the limits on golden parachutes, the \$1 million cap on the tax deductibility of certain corporate pay, and enhanced proxy disclosure. These rules have generally not reduced pay but forced corporate boards to adopt

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different and often less effective types of compensation.

- Peer group pay data are used appropriately by corporate boards. Critics believe that corporate management cherry-picks data to support large pay increases, but academic studies do not support that contention.⁷

We document and discuss these points further throughout this report.

Goals of Executive Compensation

Corporate boards design executive pay programs to attract, retain, and motivate executives to perform at high levels. Motivation plays an important role in companies' ability to achieve high returns and to encourage executives to make decisions that increase shareholder value. Incentive pay programs are particularly effective motivators, especially at the top level of businesses. The small cost savings that would occur from reductions in incentive-based executive compensation would likely be far outweighed by the resulting declines in productivity, profitability, and stock market returns.

For executives, base pay provides a stable source of income set at competitive levels, while other fixed pay and benefits are useful for attracting and retaining talent. Annual and long-term pay incentives motivate performance that contributes to the creation of long-term value. Pensions, supplemental executive retirement plans, and deferred compensation plans promote retention and company affiliation. Severance plans allow executives to take the risks necessary to maximize shareholder value even if that means jeopardizing their own jobs.

Executive pay programs must also align with broader employee pay programs so that efforts are synchronized throughout the organization. In addition, executive pay programs must send effective signals to stakeholders—especially shareholders—about the

company's strategic imperatives. And finally, pay programs must meet specific business needs within specific environments. If a company is suffering from declining revenues, for example, the pay program should reward executives for not only profitability but also for revenue growth. At the same time, for growing companies pay packages should focus on profitability and returns in excess of the cost of capital employed.

Competitive Pay Needed to Control Turnover

Any employer who underpays an employee relative to the market risks losing that employee and the value he or she brings to the company. Boards try to ensure continuity of management, but they face a constant threat of losing a CEO if more lucrative opportunities arise. This is the primary consideration of corporate boards' compensation committees when they set executive pay. The turnover rate for CEOs is very high and acts as a constant reminder to boards that CEOs can leave their jobs. In 2007 CEOs changed at 57 of the Standard & Poor's 500 companies.⁸ Between 1995 and 2006 annual CEO turnover increased 59 percent, according to a survey of the world's 2,500 largest publicly traded corporations.⁹ In the United States, almost half of the largest corporations will have to replace their CEOs over the next four years, according to a *Harvard Business Review* study.¹⁰

Many of these departing CEOs are poached by other companies. In 2005, for example, Office Depot took Steve Odland from Autozone, and Hewlett-Packard took Mark Hurd from NCR. The number two and three executives at Motorola, NCR, Bellsouth, and General Electric were recruited in the early 2000s to become CEOs at Tyco, Hewlett Packard, Sprint, 3M, and Home Depot, respectively.

The recruiting packages offered are often large, partly because successful executives usually have unvested restricted stock and stock options for which they need to be compensated when they move. In addition, companies need to offer executives upside opportunities when they come on board. However,

Table 2
CEO Pay and Corporate Costs, 2004

CEO Pay	Sales	Market Cap	Net Income	CEO Pay as a Share of		
				Sales	Market Cap	Net Income
\$6.9 billion	\$8.1 trillion	\$12.0 trillion	\$552 billion	0.09%	0.06%	1.3%

Source: Watson Wyatt Worldwide data.

Notes: The sample is 1,398 U.S. corporations. CEO Pay includes salary plus bonus plus stock options exercised plus long-term incentive payouts. Market Cap means market capitalization.

compensation committees have not “lost control” of the pay process, as critics claim, they are simply buyers of talent in a tight labor market.

The cost of a high-performing CEO quitting can be billions of dollars in market capitalization. Imagine what it might cost Apple to lose Steve Jobs. Among North American corporations, announcing the departure of a CEO with a two-year record of strong performance pulls the company’s stock price down by an average of 10.2 percentage points compared with the broad market average over a 30-day period, according to a 2007 Booz Allen Hamilton study.¹¹

Similarly, a 2003 study of 872 CEO departures by the Federal Reserve Bank of New York found that equity volatility increases following CEO turnover, even when the CEO leaves voluntarily and is replaced by someone from inside the firm.¹² These market reactions are measures of the contributions of CEOs to the success of companies.

Although CEOs have a substantial impact on corporate performance, CEO pay is a very small part of the overall cost structure of companies. Table 2 compares total CEO pay to total sales, market capitalization, and net income for a sample of 1,398 U.S. corporations. Total CEO pay in 2004 was just 0.09 percent of sales, 0.06 percent of market capitalization, and 1.3 percent of net income for the companies.

These findings are consistent with a study by Brian Hall and Jeffrey Liebman, who found that dramatic increases in CEO pay are not very large relative to the market values of

firms.¹³ Corporate compensation committees, for good reason, are not willing to risk continuity and performance in an attempt to save relatively small sums of money.

Boards also understand that the loss of key executives threatens a large portion of corporate assets in the form of disrupted strategy, hostile takeovers, loss of revenue, and other costs. The risks and costs of losing executives are clear to compensation committees, which have continued to provide high and often rising executive pay despite outbursts of public disapproval, negative media attention, and criticism of board members.

Low Supply, High Demand

High executive compensation is a market outcome caused by limited supply and high and rising demand for top talent. Consider the supply of executive talent. The number of individuals who have the ability and willingness to make the tough decisions necessary to run large companies is very small. A CEO must make complex business decisions such as pursuing capital investments that earn high returns and divesting underperforming units, even if that means downsizing an organization that the executive helped to build.

Across all U.S. labor markets where skill and experience are valued, demographic trends are creating a large number of retirements without a sufficient supply of replacements. The median age of U.S. CEOs is 56, and the average age of CEO retirement is 61.¹⁴ Fewer candidates in the lower age groups are moving into the labor

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market for executive talent. At the same time, hedge funds and venture capital funds are increasingly sucking top talent out of the corporate world because of the huge sums they can pay. John Joyce of IBM, Vivek Paul of Wipro, and Richard Bressler of Viacom are examples of highly successful executives who left the corporate world to work for private equity firms.¹⁵

In addition, as the risks and responsibilities of leading major public corporations grow, top executives can be recruited away by private companies, which can pay executives more without having to face intensive scrutiny. Also, the opening up of financial markets since the early 1980s has given U.S. CEOs greater access to capital for financing their own start-up businesses, which has raised the value of alternative entrepreneurial opportunities.

The long-term supply of potential corporate executives is also decreasing because talented people graduating with a master's degree in business administration (MBA) are entering more lucrative professions, such as investment banking, venture capital, and management consulting. While corporate boards increasingly want CEOs with MBA degrees, many of the best MBAs are moving into consulting and financial firms where the rewards can be higher and the risks lower. Among the 914 Harvard MBAs graduating in the class of 2007, 22 percent accepted consulting jobs; 20 percent moved into private equity, hedge funds, and venture capital firms; and 18 percent left the United States to work abroad.¹⁶

Although finding talented executives has become more difficult, corporate boards have faced growing pressure to terminate CEOs who perform poorly. CEOs are being fired at a high and rising rate. In 1995, one in eight departing CEOs was forced from office; in 2006, nearly one in three left involuntarily.¹⁷

Proponents of the managerial power theory claim that the "entrenchment" of CEOs and boards often leads to the failure to dismiss poorly performing CEOs. The reality is probably the opposite. There is a growing risk that boards are becoming too aggressive at dismissing executives. The pressure for accountability to shareholders has raised the

possibility that shareholders may agitate for CEO dismissal in response to short-run performance changes, even when those changes are beyond the CEO's control.¹⁸

At the same time that the supply of executive talent is shrinking, the demand for highly performing executives is increasing. One reason is that corporate boards are now looking for different skills in hiring executives than they did in the past, and the number of executives who possess those skills is extremely limited. Today, boards look for broad managerial ability, deep experience at the CEO level, and demonstrated mastery of management, finance, and other disciplines.

In addition, U.S. corporations have increased in size dramatically over the past decade, thus increasing the responsibilities of CEOs. CEOs at the largest companies now handle revenues that run into the hundreds of billions of dollars and manage tens of thousands of employees. A 2007 Conference Board report confirms that compensation for CEOs rises with company revenue, as does the portion of pay placed at risk.¹⁹ CEOs of the 10 largest U.S. corporations collectively manage more than \$2 trillion a year in revenues, an amount equal to 15 percent of U.S. gross domestic product.

Newly hired CEOs are paid much more than internally promoted CEOs, another fact that undermines the myth of managerial power. According to The Corporate Library, an independent corporate governance research group, the average total compensation of outside-appointed CEOs in 2005 was 2.6 times more than inside-appointed CEOs.²⁰ The analysis is based on a study of the compensation of 52 CEOs in the S&P 500: 32 were inside appointments and 20 were not.

In addition, the increasingly global and competitive business environment pushes boards to hire outsiders with broad skills, rather than just firm-specific skills. In an important 2007 study, Kevin Murphy and Ján Zábajník document the shift toward hiring outside CEOs who have broad managerial ability.²¹ The broader skill set needed by top corporate executives today commands higher pay in the marketplace.

Murphy and Zájbojník report that during the 1970s and 1980s, outside hires accounted for 15 percent and 17 percent of all CEO replacements, respectively. By 2005, 40 percent of all CEOs were hired from outside of companies.²² Boards have also raised their requirements for these outside hires. The percentage of outside hires with prior experience as CEO at a publicly traded company rose from less than 20 percent in the 1970s to nearly 50 percent in the 1990s. Further, boards increasingly demand that new CEOs have an MBA. In the 1970s 13.8 percent of all new hires held MBAs, which compares with 28.7 percent in the 1990s.

Murphy and Zájbojník find that the body of knowledge that must be mastered by an effective CEO has exploded. For example, CEOs increasingly must be able to communicate with external constituencies, including the capital markets, stock analysts, large institutional shareholders, and the media. In contrast to claims that executive pay is rising because the market is broken, Murphy and Zájbojník conclude that higher pay is “evidence that the market for CEOs is becoming more important in determining CEO pay levels.”²³

Another mark of a robust labor market is the substantial variation in pay for executives across companies, which reflects differences in demand and growth opportunities. Executive compensation reflects the different skills required in various industries and the degree to which CEOs can affect a company’s performance. Companies in regulated industries, for example, generally pay less than companies in unregulated industries, in part because of the more limited growth opportunities.²⁴

Executive Pay Tracks Corporate Performance

Executive pay has risen dramatically over the past 10 to 15 years, faster than inflation and faster than average employee pay. However, pay has generally not risen faster than the broad stock market and individual company share prices. Indeed, there is a tight

relationship between executive compensation and corporate financial performance, as we explore here.

To understand whether executive pay tracks corporate performance, we need to distinguish between “pay opportunity” and “realizable pay.” The key differences are as follows:

- **Pay Opportunity.** This is what a board’s compensation committee actually controls and sets, namely annual bonus opportunities and the fair or economic value of new long-term incentive awards, including stock options, time-vested restricted stock, and performance shares.
- **Realizable Pay.** This is the actual cash bonus paid, the in-the-money value of stock options, the real value of restricted stock, plus the payout from performance plans. Realizable pay is determined by the actual financial performance of companies and stock price appreciation. Compensation committees do not directly set realizable pay, in large part because committees do not know what stock price appreciation will occur when they set pay opportunity.

The key to accurately evaluating executive pay is to look at *realizable pay* compared with corporate performance over a specific period. Our research demonstrates that realizable pay closely tracks corporate performance. If both company financial performance and stock price appreciation are weak, then realizable pay will be low. If company performance and stock appreciation are strong, then realizable pay will be high. By contrast, we find no correlation between pay opportunity and company performance because *pay opportunity* is competitively set and relatively independent of recent performance.

The Data on Pay and Performance

Table 3 examines data on 1,072 major corporations in the S&P Super 1500 between 2004 and 2006. The data are broken out between companies generating high total returns to

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Table 3
Realizable Pay for CEOs and Company Performance

	Companies		Executive Compensation	
	Number of Companies	Cumulative Returns (%), 2004–2006	Cumulative Realizable LTI, \$millions	Cumulative Realizable TDC, \$millions
Companies Creating High Returns	536	99	5.2	10.5
Companies Creating Low Returns	536	17	1.7	6.0
All Companies	1,072	49	3.3	7.9

Source: Watson Wyatt Worldwide data.

Notes: LTI is long-term incentives; TCD is total direct compensation; returns refer to total shareholder returns (stock price appreciation plus dividends). All numbers and percentages are medians, except for the number of companies.

Table 4
Pay Opportunity for CEOs and Company Performance

	Companies		Executive Compensation	
	Number of Companies	Cumulative Returns (%), 2004–2006	Cumulative LTI Opportunity, \$millions	Cumulative TDC Opportunity, \$millions
Companies Creating High Returns	536	99	4.8	9.9
Companies Creating Low Returns	536	17	4.3	8.4
All Companies	1,072	49	4.6	9.2

Source: Watson Wyatt Worldwide data.

Notes: LTI is long-term incentives; TCD is total direct compensation; returns refer to total shareholder returns (stock price appreciation plus dividends). All numbers and percentages are medians, except for the number of companies.

shareholders and those generating low returns. The two right-hand columns show that CEOs in high-earning companies earned far more realizable pay than CEOs at companies with low earnings. They earned 75 percent more realizable total direct compensation (TDC), which is annual cash compensation—base salary plus actual annual incentive earned—plus the economic value of long-term incentive awards on the date of grant. And these CEOs earned three times as much in realizable long-term incentives (LTI), which comprise the in-the-money value of stock options, period-end value of restricted stock, and payouts from long-term performance plans.

These higher returns for high-performing executives are not “baked in the cake” when

executive pay packages are originally offered. The proof is that the correlation between company performance and LTI *opportunity* is very weak, as shown in Table 4. Thus, executive skill at producing high returns for shareholders is what generally determines the actual compensation that CEOs receive.

Table 5 further illustrates the alignment of pay and performance. Executives at low-performing firms earned a much smaller share of their LTI opportunity and TDC opportunity than did CEOs at high-performing companies. These results show the sensitivity between actual pay and performance among today’s executives—CEOs who do not achieve strong performance do not earn their full pay opportunity.

CEOs who do not achieve strong performance do not earn their full pay opportunity.

Table 5
Company Performance and Full Pay Opportunity

	Companies		Executive Compensation	
	Number of Companies	Cumulative Returns (%), 2004–2006	Ratio of Cumulative Realizable LTI to Cumulative LTI Opportunity (%)	Ratio of Cumulative Realizable TDC to Cumulative TDC Opportunity (%)
Companies Creating High Returns			536	99
Companies Creating Low Returns	536	17	45	79
All Companies	1,072	49	77	96

Source: Watson Wyatt Worldwide data.

Notes: LTI is long-term incentives; TDC is total direct compensation; returns refer to total shareholder returns (stock price appreciation plus dividends). All numbers and percentages are medians, except for the number of companies.

Table 6
Change in Cumulative Realizable Pay between Three-Year Periods

	Companies		Cumulative Realizable Pay (TDC)		
	Number of Companies	Cumulative Returns (%), 2004–2006	2003–2005, \$millions	2004–2006, \$millions	Change in Median (%)
Companies Creating High Returns	379	94	9.8	11.1	13.1
Companies Creating Low Returns	379	17	6.9	6.6	-3.4
All Companies	758	48	8.6	8.7	1.8

Source: Watson Wyatt Worldwide data.

Notes: TDC is total direct compensation; returns refer to total shareholder returns (stock price appreciation plus dividends). All numbers and percentages are medians, except for the number of companies.

A common myth is that CEO pay only increases over time, regardless of company performance, creating ever-higher compensation levels. Our data show that while executive pay often increases, it sometimes decreases. As noted earlier, realizable TDC depends on company performance. Not surprisingly, Table 6 shows a decrease (3 percent) in realizable TDC for low-performing companies and an increase (13 percent) for high-performing companies in the period examined.

CEOs also experience increases and decreases in annual paid cash bonuses. Table 7 shows that paid annual incentives fluctuate from year to year depending on company performance.

CEOs at low-performing companies saw a 23 percent decline in their paid annual incentives for the year shown, while CEOs of high-performing companies enjoyed a 22 percent increase.

Factors in Setting Pay

Skeptics of the efficiency of executive pay practices argue that managerial power creates upward bias in all forms of CEO compensation. They claim that directors approve excessive pay packages to curry favor with CEOs in exchange for high fees, reappointment, and special perquisites. That claim overlooks the market-based process that boards use to set

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Table 7
Change in Actual Paid Annual Incentives for Executives, 2005–2006

	Companies		Executive Compensation		
	Number of Companies	One-year Change in Returns (%)	Actual Paid Annual Incentive in 2005, \$thousands	Actual Paid Annual Incentive in 2006, \$thousands	Change in Median (%)
Companies Creating High Returns	544	28	746	907	22
Companies Creating Low Returns	544	-3	647	500	-23
All Companies	1,088	12	670	728	9

Source: Watson Wyatt Worldwide data.

Notes: Returns refer to total shareholder returns (stock price appreciation plus dividends). All numbers and percentages are medians, except for the number of companies.

U.S. CEOs are paid more, on average, than foreign CEOs because they contribute more to their firms' value.

executive pay opportunity, beginning with peer group benchmarking.

Virtually all boards use peer group benchmarking to gain knowledge of the pay levels offered by competitors. An important 2007 study of pay-setting practices found that competitive benchmarking is used to gauge the market wages of CEOs and to efficiently adjust pay as necessary to retain executive talent.²⁵

The managerial power explanation is also undermined by the fact that boards have become more, not less, independent over time. This increased independence coincides with a rise in executive compensation and the increase in CEOs hired from outside companies, which is contrary to the idea that rising pay is evidence of powerful incumbents controlling captive boards.

The Securities and Exchange Commission requires companies that use peer group data for making benchmark comparisons of executive pay to disclose the names of the peer companies in their proxy statement. Also, compensation committees aggressively seek out objective information to help them with the difficult task of setting CEO pay. Compensation committees must continuously balance two goals: retaining and motivating their executive team and minimizing company costs. Committees struggle to ensure that they do not waste corporate assets in the form of excessive pay.

Creating the right CEO pay package at the time of hiring, and at annual reviews, takes an intensive effort on the part of compensation committees. It requires data, expertise, and judgment. In addition to peer group data, compensation committees consider company performance and possible changes to company strategies, which may entail acquisitions, new product lines, and other changes. They conduct risk assessments of the voluntary departure of their CEO and the costs of replacing their CEO. In sum, compensation committees must balance many factors to motivate and retain executives while aligning their objectives with those of shareholders.

Some critics of U.S. executive pay point out that top executives in other countries are generally paid less than their U.S. counterparts. The international pay gap arises, they claim, because foreign CEOs do not have the same power over their boards. However, an important study by Randall Thomas of Vanderbilt University Law School documents the real reasons behind the pay differential.²⁶ The study finds that U.S. CEOs are paid more, on average, than foreign CEOs because they contribute more to their firms' value. American CEOs typically play a much larger role in the decisionmaking processes of their firms than CEOs at foreign firms. In addition, American firms have greater growth opportunities and

more resources to be deployed because they are often larger. Furthermore, American CEOs receive more of their pay in the form of stock options, and may hold more of their wealth in company stock than foreign CEOs, thus their higher pay also reflects a risk premium.

“Fixing” the Market for Executives

The issue of CEO compensation has often become political fodder, which has prompted federal policymakers to enact new laws and regulations to control various elements of executive pay. In the 1992 presidential campaign, Bill Clinton promised to “end the practice of allowing companies to take unlimited tax deductions for excessive executive pay.”²⁷ More recently, both major candidates in the 2008 presidential election have lashed out at what they perceive to be excessive pay for executives.²⁸ History teaches us, however, that federal “reforms” and new regulations distort markets and will likely have unintended consequences.

Direct regulation of executive pay occurs through the actions of the Securities and Exchange Commission, the Financial Accounting Standards Board, and the Internal Revenue Service. In addition, Congress occasionally passes legislation that attempts to control executive compensation practices.

One example of the unintended consequences of new federal rules arose from the recession of the early 1990s. At the time, critics argued that inefficient executive pay policies were hurting America’s ability to compete in the international marketplace. That concern led to legislation passed in 1993 creating Section 162(m) of the Internal Revenue Code, which eliminated corporate tax deductions for executive pay in excess of \$1 million that was not deemed to be performance-based pay. But rather than limiting executive pay as intended, Section 162(m) led to dramatic increases in the use of performance-based compensation, particularly stock options, which subsequently came under attack as a source of excessive compensation.

Concerns about excessive executive pay during the 1990–1991 recession also touched off new disclosure efforts. In 1992, the SEC issued rules that required greater executive compensation disclosure. As with most reform efforts, however, this too had an unintended consequence. With enhanced disclosure, executive pay levels were transparent to all, which worked to the benefit of those executives who were undercompensated relative to the norm. Those executives then demanded higher compensation.

In the mid- to late 1990s, criticisms of executive pay and efforts to reform it diminished as the economy flourished and shareholders reaped large returns. Throughout the 1990s, the stock market continued its climb virtually unabated. When the bubble popped in the 2001 recession, it was clear that the excessive use of options by some companies had led to a short-term focus and, at a few companies, illegal behavior. After the Enron scandal broke in the fall of 2001, a rush of external pressures pushed open the door for radical changes in the laws and regulations related to executive pay, including most notably the Sarbanes-Oxley Act, signed into law in 2002.

One of the more important parts of Sarbanes-Oxley for executive compensation is the prohibition on executive loans. Because of this prohibition, boards now need to be more creative in how they induce executives to join their companies, often leading to more costly alternatives such as restricted stock awards, up-front signing bonuses, and enhanced severance. Ironically, these are all now criticized as “pay for nonperformance” and as evidence of inefficient executive pay structures.

Although U.S. executive compensation was already the most transparent in the world, the SEC issued new executive compensation disclosure requirements in early 2006. However, as often happens, the market reacted more quickly than regulatory bodies did, and had already implemented improved disclosure. The new disclosure rules may serve to reduce the outliers, but for most companies the new rules simply mandated what had already

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Competitive pressures already work effectively to reform executive pay practices over time.

**Table 8
Company Stock-Option Grants after FAS 123R**

	2004	2005	2006	Percentage Change	
				2004–2006	2005–2006
Grant Size (run rate)	1.6%	1.4%	1.1%	-31%	-21%
Total Estimated Grants, \$billions	\$52	\$43	\$40	-23%	-7%

Source: Watson Wyatt Worldwide data based on companies in the S&P Super 1500. The data for 2004 is prior to the rule change.

become a best practice in executive compensation.

The Financial Accounting Standards Board also rode the momentum of the post-Enron era and put in place mandatory stock-option expensing under FAS 123R, effective for fiscal years beginning after June 15, 2005. This change has also produced unintended effects. One effect is that many companies have reduced the number of employees who can participate in equity programs. In the late 1990s, the trend among employers was to grant more stock options to more employees, but with the expensing requirements of FAS 123R, those plans have been scaled back.

This unintended effect of FAS 123R is disturbing because it reduces performance-enhancing incentives for nonexecutive employees, which minimizes the alignment of incentives throughout organizations. If anything, we should strive to make the pay model for all employees more like the executive pay-for-performance model, not less.

The impact of FAS 123R is borne out by both the magnitude of stock-option grants and their value. Table 8 shows that total grant size, as measured by the run rate (defined as stock options awarded as a percentage of a company's common shares outstanding), declined by almost a third from 2004 to 2006. Also, the estimated value of options granted has declined from \$52 billion in 2004 to \$40 billion in 2006.

In the post-Enron environment, the IRS also saw an opportunity to further regulate executive compensation. IRS scrutiny of non-qualified deferred compensation plans ulti-

mately led Congress to pass legislation creating Section 409A of the tax code. The new rules created significant restrictions on deferred compensation programs. As a result of Section 409A, and the reduced income tax rates of recent years, the prevalence of deferred compensation is likely to decline. That is unfortunate because deferred compensation denominated in company stock is an effective way to promote long-term shareholder alignment and share ownership.

Executive Pay Practices Self-Regulate over Time

All these new rules as well as other federal interventions are misguided because various external and competitive pressures already work effectively to reform executive pay practices over time. Increasingly aggressive shareholder scrutiny, especially from institutional investors, has created substantial pressure on executive pay practices. For example, large institutional investors, and the organizations that advise them, generate detailed corporate governance reform recommendations. These groups wield substantial power, and corporate boards are highly sensitive to their recommendations.

The largest mutual funds also monitor and evaluate executive pay practices; and union-sponsored funds are another forceful voice. Other organizations have also stepped up their efforts to monitor and influence executive compensation policies, including the Council of Institutional Investors and Institutional Shareholder Services, Inc.

In response to suggestions from these

groups, and to keep up with the growing body of knowledge about best practices in compensation, boards are increasing the portion of performance-based pay in overall pay, reducing severance, and reducing perquisites and executive pensions. Some companies, for example, are reducing cash severance payments or moving from single triggers to double triggers on equity-vesting acceleration.²⁹ Other companies are eliminating or modifying change-in-control gross-ups, which compensate executives for excise taxes imposed on severance packages. Boards are also reducing executive benefits and perquisites that have been particularly criticized. From 2005 to 2006, the median total value of benefits and perquisites for Fortune 100 CEOs declined slightly.³⁰ In 2006, 16 percent of Fortune 100 companies reported that they were eliminating some perquisites for executives. All of these recent reforms reflect the fact that the executive labor market and the pay levels it produces self-regulate over time.

Conclusion

Many types of evidence indicate that the market-based and competitive executive pay model in the United States is very effective. But the private sector should continue to refine best practices to sustain this effectiveness, while identifying specific shortcomings that companies should address on a voluntary basis. At the vast majority of companies, boards work hard to determine the right mix of executive incentives in order to achieve maximum performance for shareholders.

The managerial power theory—that executives are not compensated in an open and competitive manner—has contributed to meaningful and ongoing discussions about corporate governance. However, when that theory is taken too far, it leads to fundamental misunderstandings about executives, their pay levels, and their role in building successful corporations. These misunderstandings sometimes lead policymakers to impose damaging regulations on the labor market and on

a pay model that is critical to vigorous business expansion and American economic growth. Occasional excesses in executive pay can be dealt with without regulating the overall market and abandoning the core model of pay-for-performance.

Whether corporate success is measured in stock price performance, productivity, or employment, it starts at the top of the corporate structure. The U.S. corporate model that has generated so much wealth for American citizens will be seriously damaged if we take away or severely restrict the system of risks and rewards that attracts talented executives and pays them to make the right decisions on a sustained basis.

Notes

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