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# With CEO Pay, Size Does Matter

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Shortly after Christmas last year, a pair of mathematically inclined, French-born, U.S.-trained economists considered the speculation surrounding why chief executive officers are paid so much more these days -- and they saw a puzzle to be solved. Not whether CEOs deserve the money, but why do the 500 largest U.S. companies pay CEOs six times as much as in 1980, adjusted for inflation? Not why did a few diabolical CEOs get so much, but why did the average rise so much?

Theories abound. Cozy, corrupt or incompetent boards are letting CEOs rip off shareholders. Today's CEOs won't work hard without lucrative incentives. A CEO's job is riskier or harder than it used to be. Xavier Gabaix, a 35-year-old Harvard Ph.D. now teaching at Princeton University, and Augustin Landier, 31, a Massachusetts Institute of Technology Ph.D. now at New York University, offer a strikingly different take: It's the competitive market, stupid.

Ah, the all-purpose economist explanation for everything. It's supply and demand. But the Gabaix-Landier argument has created such a buzz among academics since the pair began circulating a paper six months ago that it seems worth considering this alternative to the cynical view -- that CEOs are crooks -- for which the scandal over backdating of options provides support.



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• To read the Gabaix-Landier paper: http://www.princeton.edu/~bcf/Seminar06/GabaixPaper.pdf[1]

• For more on Gabaix: http://econ-www.mit.edu/faculty/index.htm?prof_id=xgabaix[2]

• For more on Landier: http://pages.stern.nyu.edu/~alandier/[3]

• Read Gary Becker's commentary on the paper:

www.becker-posner-blog.com/archives/2006/05/are_ceos_overpa.html[4]

• Read Greg Mankiw's commentary on the paper: http://gregmankiw.blogspot.com/2006/10/gabaix-on-ceo-pay.html[5]

• More critiques of the paper: http://economistsview.typepad.com/economistsview/2006/05/are_ceos_overpa.html[6]

It is obvious that the bigger the company, the more the CEO gets paid. That fact has inspired more than a few big acquisitions. An old rule of thumb holds that for every 10% increase in a company's size, the CEO's pay goes up 3%. But that doesn't explain recent patterns.

Messrs. Gabaix and Landier, squash partners who majored in mathematics at the École Normale Supérieure in Paris, realized that it isn't only how big a company is that matters; it is how big other companies are. It is about keeping up with the corporate Joneses.

And how much did U.S. companies grow in the past 25 years as CEO pay rose sixfold? Measured by stock-market capitalization, the value of all their shares, the companies grew *sixfold*, the pair discovered. "If all companies increase in size," Mr. Landier says, "the amount people are willing to pay for the same talent goes up."

Everything else is detail, but the details are interesting. CEOs aren't better than they were a quarter century ago, and there isn't much difference among them. But being a little bit better CEO than your competitor is worth a lot of money, just as it is to superstars in opera or baseball.

If the No. 1 CEO -- the best -- was replaced by No. 250, how much difference would that make to the No. 1 company's market cap? It would fall 0.016%, the economists calculate. But 0.016% of the $362 billion market cap of **General Electric** Co. is nearly $58 million. "Very small talent differences translate into considerable compensation difference as they are magnified by firm size," they argue.

If Messrs. Gabaix and Landier are right, tweaking corporate-governance rules won't restrain CEO pay. "Firms with bad corporate governance pay the CEO more, but it's a really small effect -- only about 10% on average," Mr. Gabaix says. Outrageous exceptions, he says, shouldn't drive policy.

Perhaps. But Harvard labor economist Lawrence Katz points out that the Gabaix-Landier model suggests that if the No. 15 company has a deviously clever CEO who finds a new way to engorge himself (think backdating, again), then the impact of that behavior will be magnified as it spreads to CEOs of even bigger companies.

And if they are right, then CEO pay hasn't much to do with motivating CEOs to work harder, and there is little economic harm to be done by taxing them more heavily.

"CEOs are paid what they're worth to their companies, and their high pay reflects the extraordinary value of their talent," Gregory Mankiw, another Harvard economist and a former adviser to President Bush, wrote on his blog after a Gabaix seminar. "But the supply of talent is inelastic" -- that is, paying more wouldn't produce more Jack Welches -- "and the allocation of talent would not be affected if everyone faced high tax rates." (Messrs. Gabaix and Landier shudder at this suggestion.)

These French math whiz kids haven't explained everything. The market cap of U.S. companies rose mightily from the 1940s through the 1970s, yet CEO compensation didn't soar much faster than the typical worker's pay.

What changed? Frank Levy, an MIT economist, has a hunch: "Coming out of World War II, and the Great Depression before that, a lot of people were very afraid of extensive labor unrest. The whole framework of collective bargaining, a decent minimum wage, high marginal tax rates, etc., were all designed to head that off."

For a while, fear topped greed. But fear of unions and of government restraints on the market forces Messrs. Gabaix and Landier describe faded around 1980. Greed took over.

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