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ECONOMIC SCENE

A Contrarian Look at Whether U.S. Chief Executives Are Overpaid

By TYLER COWEN

FROM 1980 to 2003, the average compensation of an American chief executive at a top 500 company rose by a factor of about six. The average compensation for the chief executives 0f these top companies reached roughly $11 million a year, including the value of options. No other country pays so much. For instance, American chief executives received roughly four times what their Swedish counterparts in comparably sized companies did and 3.1 times that of a Japanese chief at a comparably sized company.

Not surprisingly, many people think the American executives are overpaid. Their salaries are set by corporate boards, often filled with insiders or friends. Salaries for the top executive are far from transparent, especially when stock options and complex compensation plans are used. Nor is pay always linked to performance. Kenneth L. Lay received a salary and bonus of more than $8 million plus perks in 2000, less than a year before Enron's collapse.

But in a new paper, "Why Has C.E.O. Pay Increased So Much?" (http://ssrn.com/abstract=901826), the economists Xavier Gabaix of the Massachusetts Institute of Technology and Augustin Landier of the Stern School of Business at New York University offer a contrarian view. They suggest that the higher salaries for chief executives can largely be explained by increases in the value of the stock market. Viewed as a whole, these salaries are a result of competitive pressures rather than the exploitation of shareholders.

Their core argument is simple. If we look at recent history, compensation for executives has risen with the market capitalization of the largest companies. For instance, from 1980 to 2003, the average value of the top 500 companies rose by a factor of six. Two commonly used indexes of chief executive compensation show close to a proportional sixfold matching increase (the correlation coefficients are 0.93 and 0.97, respectively; 1.0 would be a perfect match).

So how does this argument work? Better executive decisions create more economic value. If the number of big companies is greater than the number of good chief executives, competitive bidding will push up pay to reflect the value of the talent.

As Professors Gabaix and Landier predict, chief executives' salaries in different sectors are higher when the capitalization of that sector is higher. A stronger sector means more bidders for a chief executive of a particular kind; an executive who has run one car company can go run another. Chief executives in large industries, therefore, receive more, even after adjusting for the size of their current companies. Business services, computers and banking turn up as exceptions for this comparison; their top executives are overpaid relative to what market capitalization alone would imply. Perhaps chief executives can add more value in more dynamic sectors.

The authors are still working on their international comparisons; it is difficult to compare compensation across countries. But the preliminary results suggest that the total value of the companies in the sector helps predict how chief executives' salaries vary from country to country. Executives of large companies in France have fewer outside opportunities in comparable companies than their American counterparts and they thus receive less compensation, in this case by a factor of 2.4 to 1.

The approach of Professors Gabaix and Landier to executive compensation is influenced by their French background. In the United States, the popular debate turns on merit — whether chief executives are worth the money. In Europe, where inequality is less socially acceptable, the popular debate concerns whether anyone could possibly deserve so much money. This perspective led Professors Gabaix and Landier to focus on explaining the overall level of executive compensation, opening up a new approach to the problem.

The two also find that the best chief executives do not seem to have much more talent than other chief executives in what they define as the top 250. By their calculations, replacing the No. 250 chief executive with the No. 1 will increase the value of the company by only 0.014 percent. The No. 1 chief executive receives much more compensation, but that is mostly because he manages a larger company and thus his talent has a longer reach. That is another way of thinking about why the same chief executive will make more money in a larger marketplace or in a larger country.

The Gabaix-Landier argument does not cover all objections. We do not have adequate data for longer stretches of American history. There are important cultural differences across countries. Lucian A. Bebchuk of Harvard Law School, a leading critic of chief executives' pay, argues in response to the paper that pay remains insensitive to performance, that high executive pay is correlated with bad corporate governance and that chief executives take great care to hide their true compensation. For those reasons, he does not believe that executive pay is driven by productivity.

In any case, the debate over chief executives' salaries has moved a step forward. Yes, there are numerous examples of corporate malfeasance. But it is not obvious that the American system of executive pay — taken as a whole — is excessive or broken. The critics contend that chief executives cheat public shareholders. But private equity typically pays its top executives very well, even though public shareholders are not a factor. Furthermore, the rate of productivity growth in the United States has been the envy of the world. Chief executives must be doing something right.

The growth in executive compensation reflects how much more is at stake in American companies. Is not the real question which policies and institutions have led to this explosion of value?

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