The Executive Compensation Controversy: A Transatlantic Analysis

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May 2010

THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

CENTRE for ECONOMIC PERFORMANCE

Summary

- Paper is a great historical discussion of the development of US CEO pay, especially over equity based remuneration

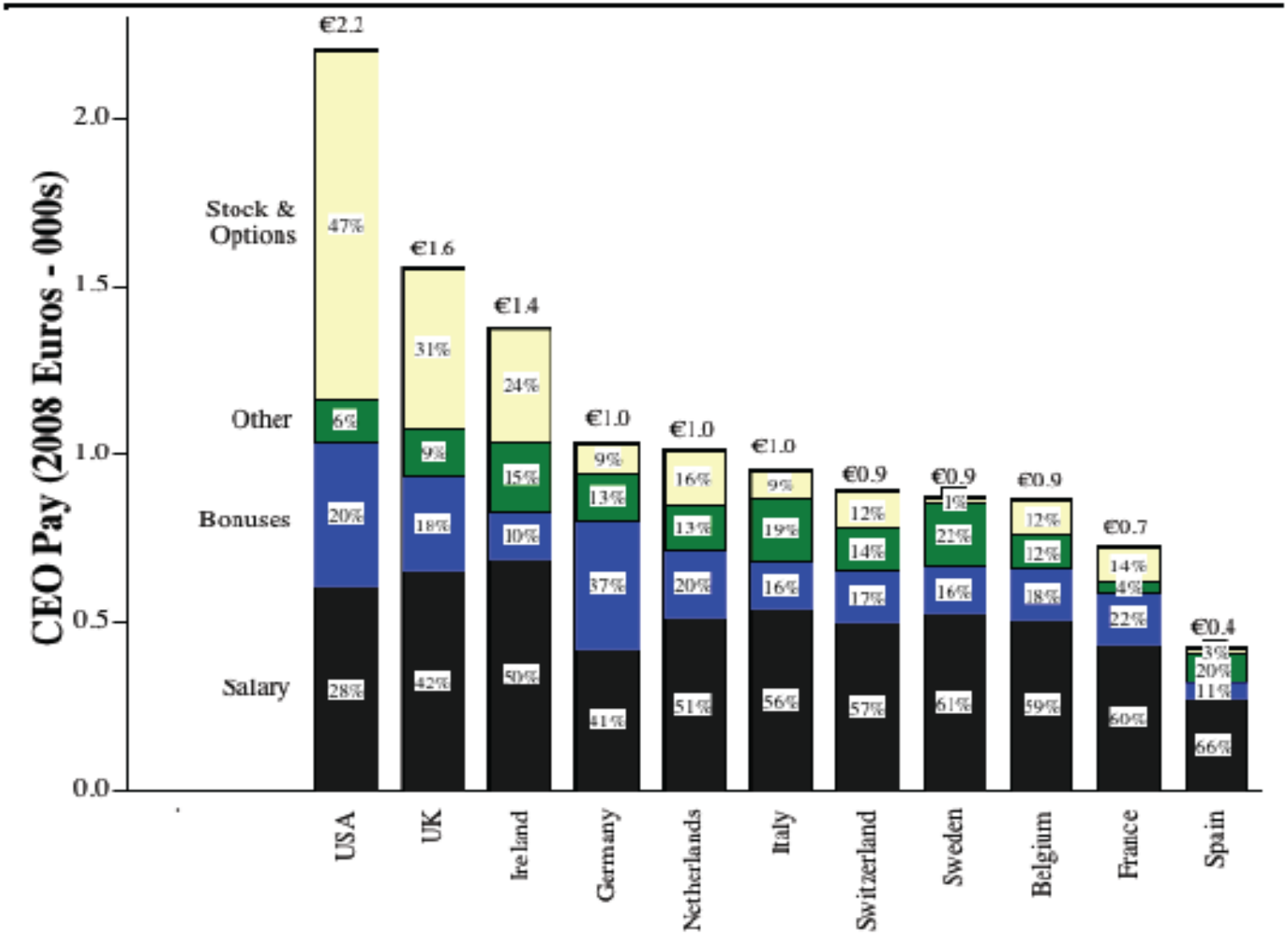
- Treasure trove of basic facts exploiting recent data on CEO pay comparing US to EU

- 3 sections
  - US history 1950 onwards
  - US/EU differences
  - Financial crisis

Basic Facts

- Median US CEO real compensation
  - 1983-1991 4.3% p.a.;
  - 1991-2001 15.7% p.a.;
  - 2001-2008 1.7% p.a
- CEO compensation in US about twice as large as EU average
- Base salary (and bonus) similar US/EU. Differences is in stocks and stock options (see figure 3.1)
  - But a puzzle is why??

Figure 3.1 2008 CEO Pay in the USA and 10 European Countries after controlling for Sales and Industry



Note: The figure compares 2008 CEO pay (in €000s) in each country controlling for firm size (sales) and industry. We regress the logarithm of total compensation on the logarithm of sales and 5 industry and 11 country dummies. For each country, we estimate the pay for a CEO running a hypothetical firm with $1 billion sales using the estimated coefficient for pay-size sensitivity and that country's dummy variable for a CEO in the largest industry group (manufacturing, energy, and utilities). Countries are sorted in descending order in terms of total estimated pay.

Issues

1. What is the effect of CEO incentive pay on company performance?
2. Incentive Pay & Financial Crisis
3. The EU/US Gap: what’s special about CEO Pay?
4. Policy Implications
5. Other Issues

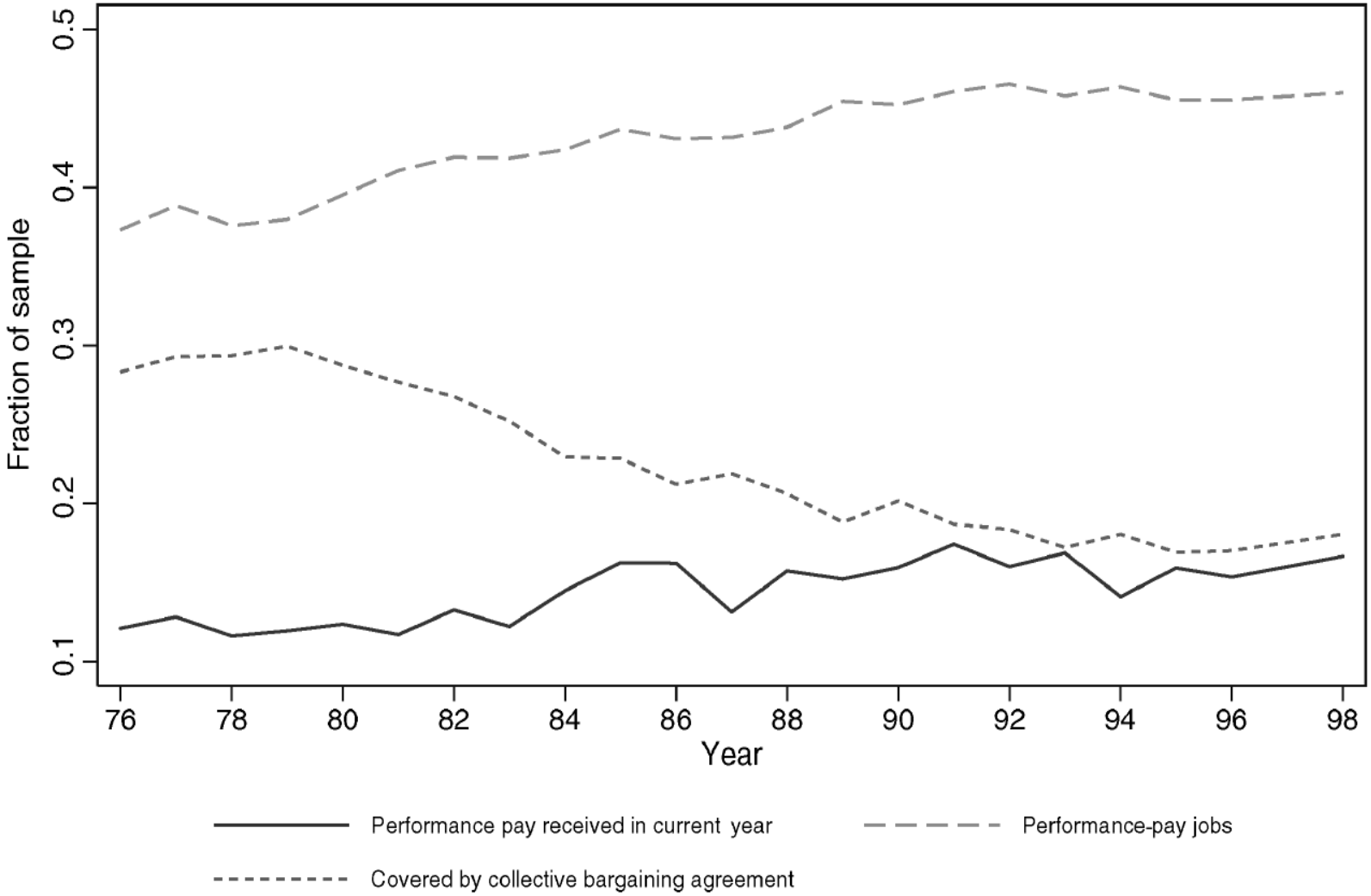
1. What is the effect of CEO incentive pay on company performance?

- Unclear what authors think about link between incentive pay (e.g. Stock options) and performance of CEOs
- **Positive?**
  - Discussion of Gabaix-Landier (2008)
  - They support move towards more incentive pay in EU
- **Negative?**
  - They explain growth of options to changes in accounting/tax rules rather than to fundamentals
- Would be good to see review of best empirical studies
- Cf. Bloom and Van Reenen (2010) “HRM and Productivity” in *Handbook of Labor Economics IV*
    - Incentive pay appears to have positive link to productivity for ordinary workers

2. The EU/US Gap: what's special about CEO Pay?

- In cross section, US inequality is higher than EU at every point of the wage distribution
- In time series US inequality has growth much more quickly than EU countries since 1980
- Most theories suggest something "special" about CEOs: superstars, managerial power, tax/accounting rule changes, etc.
- But how much of this just following same trends as rest of US wage inequality patterns (e.g. skill biased technical change, trade, union decline)?
- Would be useful to examine how different are CEO trends from say evolution of 99th percentile, 90th percentile, etc.

Incidence of Performance Pay, US men in PSID, 1976-1998



Source: Lemieux, McLeod and Parent (2009, QJE)

Notes: Male heads of household earning between $1 and $100 per hour. Self employed and public sector excluded. 30,424 observations on 3,181 workers. Performance pay in current year=1 if any part of compensation includes bonus, commission or piece rate. Stock options and shares are not included. A performance pay job is one where the worker *ever* receives some performance pay over the life of the job-match.

3. Bankers' bonuses & Financial Crisis

- Incentive pay particularly strong in finance. Conyon et al argue that CEO incentives nothing to do with financial crisis. I am not so convinced
- Bell & Van Reenen (2010) show that increase in share of top decile 1998-2008 from 27% to 30%. Mainly to top 1% and most of this (£12bn) was bankers' bonuses
- Banks moral hazard problem. State bail outs provide insurance leading to more risky behaviour (Garicano & Van Reenen, 2010)
- Not just CEOs, traders too. Table 4.1 In 9 largest Wall St banks, 4,793 employees received more than $1m in bonuses, 800+ more than $3m. By contrast empirical analysis of banks more affected by crisis looks at CEOs only

Policy Implications

- I agree that short sighted “punitive” CEO pay regulation bad idea
- But UK one-off 50% tax on bankers justified because bank profits were earned largely because of taxpayer bail out of banking system.
- I am not convinced that moving to US CEO pay would bring improvements in EU corporate performance
- Perverse pay systems are the <u>symptom</u> of moral hazard problem in banking sector. Need to tackle <u>root causes</u> through higher capital requirements, enforced transparency, living wills and <u>reducing bank size</u>
- “If banks are too big to fail they are too big” (Mervyn King, Governor of Bank of England)

Other Issues

- Cross national comparisons with BoardEx when looking at market cap are difficult because focus is on public firms.
  - But many EU countries (e.g. Germany) relatively small fraction of large firms on stock market.

- If story is that accounting/tax changes drive options & stock this can only explain why EU/US pay gap larger post 1992. US/EU pay gap preceded this, so what causes this long-standing difference?

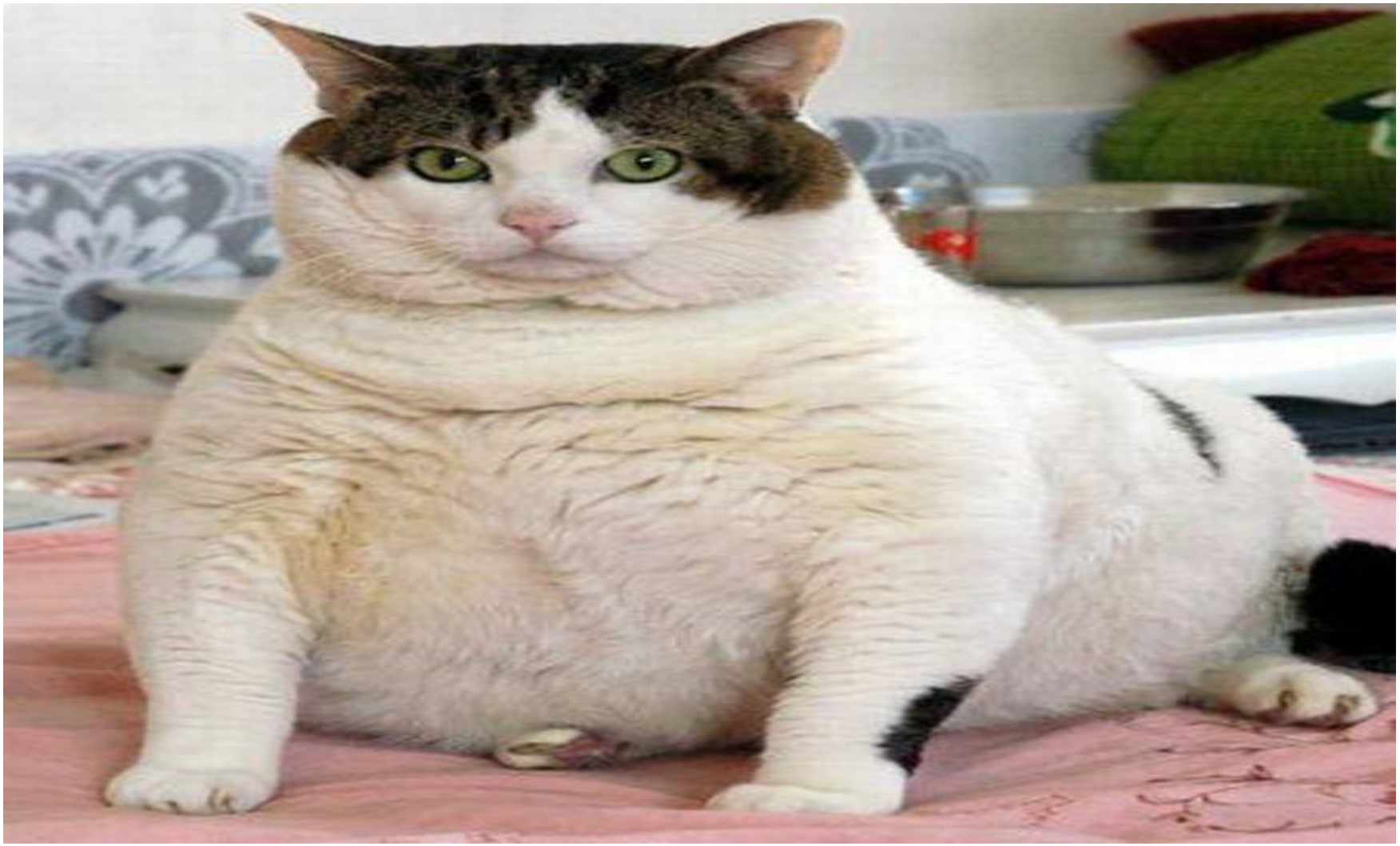
- Institutional investors associated with higher pay, but what about incentive pay? Aghion, Van Reenen & Zingales (2009): institutions improve performance

Conclusions

- Great paper – really informative and full of basic facts. Well written

- Popular debate revolves solely around “banker bashing” (e.g. Recent UK election) . This paper injects welcome historical dimension and reason

- Next step to look more carefully at economic consequences



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1990s “Perfect Storm” explaining rise of US stock plans

- Government introduces law that CEO salary above $1m is not tax-deductible for corporate taxes
- But options excluded from this (a “safe harbour”)
- After years of speculation that options would have to be expensed on accounting statements FASB decided to continue with old rules
- Govt policies and listing rules promoted broad based grants
  - “non theoretic story”
  - Need to expand. Seems to require some corporate governance problems
  - Behavioural story?