
Are CEOs Paid Too Much?

BY ROBERT P. MURPHY

One of *Reader's Digest's* more popular sections is “That’s Outrageous!” When the feature spotlights government pork-barrel projects, absurd zoning restrictions on homeowners, or illogical regulations on small business, libertarians can applaud. Unfortunately the October 2005 issue featured a column that focused on “outrageous” CEO packages, an enduring controversy. The writer, Michael Crowley, displayed precious little knowledge of economics, and at times his complaints were downright contradictory.

The article begins with the anecdote about Stephen Crawford, then the co-president of Morgan Stanley. A few months after accepting this promotion, Crawford quit during a “management shake-up” and “strolled off with a severance package that included two years’ salary and bonus,” which amounted to \$32 million. To make sure his readers are sufficiently outraged, Crowley points out that “Crawford pulled in \$54,000 *per hour!*”

Before delving into the conceptual issues, let’s be clear on where that number comes from. It is obviously due to Crawford’s quitting much sooner than anyone (probably including himself) predicted when the contract was originally negotiated. (Had the shakeup occurred six weeks earlier, Crawford would’ve earned over \$100,000 per hour, according to this method.) This is certainly a misleading approach, especially when contrasting it with the mean annual earnings of workers (as Crowley does). If one wants to show how much more CEOs get paid—and of course they *do* get paid far, far more than the average worker—then a fairer comparison would have been mean annual earnings of workers versus *mean annual* earnings of CEOs. (Later, Crowley follows this more reasonable route and reports that in 2003 “CEOs were paid over 300 times what the average

production worker made.”) To pick an example like Crawford rigs the comparison; one could certainly find cases of average Joes who quit or were laid off after only working a very short time, and hence whose “hourly earnings” would appear vastly inflated.

For example, I myself was once sent home after only working about ten minutes as a receptionist in a law firm; I had been sent there by my temp agency, and it turned out I was unfamiliar with the phone system at the firm. Nonetheless, I still got paid for at least one hour (possibly more, I can’t remember) of work. Using Crowley’s approach, he could argue that the case of Robert Murphy shows that some Irish workers are paid six times more per hour than the median temp worker.

Even on its own terms, the calculation is suspect. Crowley isn’t explicit about where the \$54,000 per hour figure comes from, but we do know that the total package was \$32 million and that Crawford quit “[a]bout 100 days” after starting in the new spot. Well, \$32 million divided by 100 is \$320,000 per day, which works out to \$40,000 per hour if we assume eight hours of work per day. Thus to get the higher figure of \$54,000, Crowley must be assuming that, in addition to working only eight hours per day, Crawford only worked five days per week. Now I don’t know too much about being co-president of Morgan Stanley, but even so, I’m quite sure that this job requires more than 40 hours of work per week.

Of course, these minor quibbles about the figure overlook the biggest objection: So *what* if CEOs earn more money than most other workers? In a free market (and below we deal with the complication that in today’s world there *is* no truly free market), the price of labor

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corresponds to its marginal product. That is, competition ensures that workers are paid according to how much additional revenue they bring in to their employer. The fact that some types of labor command thousands of times more market value is no more surprising or outrageous than the fact that some goods in the marketplace (such as a house) have a price hundreds of thousands of times higher than the prices of other goods (such as a pack of gum).

Oddly enough, it is the *critics* of capitalism who implicitly claim that market value should correspond to ethical worth. No competent economist would argue that Stephen Crawford was a good person because he earned so much money, just as no economist would argue that a television set is ethically superior to a copy of the Holy Bible because of its higher price. No, the only thing economic science can say is that Stephen Crawford's services were in higher demand than the services of (say) the janitors at Morgan Stanley. So long as the labor contracts are voluntary, there really isn't an issue of fairness (subject to the complication noted above).

Later in the article, Crowley raises concerns that may trouble even a genuine supporter of the free market. Of course it makes perfect sense that successful corporate executives earn millions of dollars. But what of the strange cases of "corporate leaders actually *failing* their way to riches"? Crowley gives us some allegedly outrageous examples of this trend:

Viacom CEO Sumner Redstone took home about \$28 million in 2004, including a bonus of \$16.5 million, even as his company's stock dropped 11 percent during the fiscal year. Applied Materials CEO Mike Splinter got a tidy \$5 million bonus in 2004, despite a stock slide of more than 22 percent. That same year Rick Wagoner, CEO of General Motors, saw GM stock plunge 25 percent, yet he still pocketed a \$2.5 million bonus—only slightly less than his award in 2003, when GM stock actually rose. So much for accountability.

As noted, this phenomenon is initially quite puzzling. Why would firms reward incompetent executives? Don't they want to make money? Yet before dismissing power brokers in the business community as self-

destructive and/or incredibly stupid, perhaps we should give them the benefit of the doubt and search for a rational explanation.

The most important point that scoffers like Crowley overlook is that the business world is uncertain. When a company brings in a new executive, it is not at all obvious what steps he or she should take to turn the company around and boost profits. (If it *were* obvious, the company wouldn't waste millions of dollars hiring the executive.) Now regardless of the executive's competence, it is entirely possible that the plan will fail—and the executive knows this as well as anyone else. Because of this, it would be very risky for such an executive to sign a contract in which, say, he or she earned \$20 million if the company were profitable, but \$50,000 if the company tanks. Rather than sign *that* contract, the executive (who must be quite skilled to be offered such a job in the first place) could consult or take a less glamorous position and earn, say, \$5 million for sure.

This principle—that an executive gets paid handsomely even if the company does poorly—doesn't seem outrageous when the numbers are lower. For example, when GM stock plunged 25 percent, did Crowley expect the assembly-line workers to give back a quarter of their wages for that year? If not, why not? After all, if the public stops buying GM vehicles, the services of the assembly-line workers aren't as valuable. The simple answer, of course, is that the assembly-line worker doesn't want his contract contingent on the overall profitability of the company; he wants to be paid—and to get his pension and other benefits should he retire or quit—whether or not the company's stock does well. If it's acceptable for the assembly-line workers, why not for the CEO too?

Greater Influence

Naturally, there is one obvious difference in this respect between assembly-line workers (or janitors and receptionists) and CEOs: Far more so than these other employees, the CEO can greatly influence the profitability of the company. Rather than giving the CEO a well-specified set of instructions to mechanically implement, the people hiring him allow far more discretion. After all, the CEO is brought in to run the company.

Yet this difference shows up quite clearly in the market: CEOs and other executives *do* get paid according to how well the company does. In addition to a base salary, these executives are often paid in stock options. A stock option (specifically a *call*) gives its owner the right to purchase shares of stock at a specific price, called the strike price. Therefore, if the actual market price of the stock is lower than the strike price, the option is worthless. But if, through their behavior, executives can boost the company's stock price above the strike price, the options are valuable in proportion to the difference between the strike and actual prices.

Given his outrage over executives being paid regardless of profitability, one would expect Crowley to be a huge advocate of paying CEOs in nothing but stock options, which perfectly tailor earnings to the success of the company. Yet Crowley complains about the fairness of this too, even with highly successful companies. He cites the case of Yahoo! CEO Terry Semel, who took advantage of \$230 million in stock options in 2004:

The average Joe might be more outraged if he understood the sorts of payouts and benefits that corporate brass are getting. Stock grants still provide a windfall for many chief executives, despite new regulations that force companies to account for options as expenses. Yahoo! CEO Terry Semel exercised \$230 million in options last year. His company has had strong earnings of late so it's fair to say that Semel earned his \$600,000 salary, plus a hefty award for boosting the stock price. But \$230 million? Come on.

Now what exactly is Crowley's definition of *fairness*? If Semel is paid a large chunk of options, and under his leadership Yahoo! stock rises tremendously, why shouldn't he be rewarded in proportion to this gain? At this point we can see past Crowley's other alleged arguments; his basic objection is obviously that \$230 million is more than *anyone* should earn, period.

Arbitrary Limit

There are three problems with this popular view. First, the upper limit that "decency" allows is arbitrary; no doubt many people would also deny the fairness of Semel's \$600,000 base salary. ("We've got starving children in the streets and some guy who heads a company of spammers gets 600 grand a year?!")

Second, we must accept that in the modern economy, with billions of potential consumers worldwide, certain individuals have extraordinary earning power on the open market. If someone like Semel (or, a stronger case, Bill Gates) can add hundreds of millions of dollars of value to an organization (as judged by the spending habits of consumers), then to *not* pay him accordingly just means that someone *else* gets the money. Whatever

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happened to the principle of labor being paid the full value of its product? If Semel only got, say, \$1 million, then Yahoo! shareholders (a group hardly in need of charity) would be \$229 million richer. Would this outcome be fairer than what actually happened?

Third, we must consider the problem of incentives. If certain market exchanges are prevented because people such as Crowley find them unconscionable, then the individuals involved may stop working as much or as hard. For example, if Semel knew that outsiders would confiscate his stock

options if the stock price rose too much, then he wouldn't have put in the long hours and sleepless nights that he undoubtedly did during the year in question.

This is a point liable to misinterpretation, and it's probably easier to switch contexts to professional sports. Economics tells us that placing a limit of, say, \$1 million on salaries would reduce the incentives for star athletes. Now the critic might scoff and say, "Come on! Whether they make \$1 million or \$30 million, people will still go into the NBA. That type of cap isn't going to affect anybody's career choice." Yet this objection overlooks the *marginal* nature of economic decisions. Yes, a first-round draft choice will still go pro (rather than become an accountant) even with a \$1 million cap. But he'll probably retire much earlier. (In the extreme, consider the

heavyweight champion of the world—once he earns his title, he won't defend it nearly as often if people like Crowley get to dismiss multimillion-dollar payments as unfairly high.)

This reasoning applies even more so to leadership positions in large companies. Especially when considered in the aggregate, if "outrageous" compensation packages are forbidden, the quality of corporate leadership will suffer. These people aren't qualified for *just* CEO spots, and they're well aware of the social stigma against big business. If the compensation packages are as high as they are, it's because that's what firms need to offer to attract and retain these highly skilled individuals. Of course, this phenomenon isn't peculiar to corporate-leadership positions; if we declared tomorrow that brain surgeons could only make 50 percent of their current salaries, the frequency and quality of brain surgery would plummet.

Entrenched Management?

Of course, any reader who has actually worked in (or owns stock in) a large corporation may reject the above description as naïve. In the real world, such a reader might object, most shareholders in practice exercise no control over management. Suppose, for example, that 85 percent of the shareholders (consisting of thousands of people who each owned far less than 1 percent of the stock) thought the CEO made far too much money. Even so, would it really be worth it for them to organize and demand that the corporate board do something? After all, the increased dividends made possible by such cost-cutting wouldn't translate into very much per shareholder. In this environment, management becomes entrenched and a lavish corporate culture takes over, with kept board members approving the jet-setting lifestyle of the CEO and his cronies.

As some of the recent scandals suggest, there definitely seems to be at least a grain of truth in such claims. Yet it nonetheless remains a puzzle to the free-market economist. For even if individual shareholders wouldn't find it worthwhile to organize and put an end to profli-

gate abuses by management, such waste would nonetheless show up in the *stock price* of the firm. If, for example, management collectively frittered away \$10 million per year in unjustifiable expenses, the total shares of the corporation would be valued around \$200 million less than they otherwise would be, assuming an efficient stock market and an interest rate of 5 percent. (This is because \$200 million is the present discounted value of a perpetual stream of \$10 million annual dividends.) Such a corporation would then be a prime target for the much reviled *corporate raider*. The raider would institute a "hostile takeover," in which he bought up a controlling share in the corporation (by offering far more than the current price per share to the stockholders) and then used his power to fire or straighten out the inefficient managers. After cleaning house the corporation's dividends and/or stock price would rise accordingly, netting the raider a profit.

Thus we see that in the free market, even the realistic problems with "democratic" mechanisms can always be overcome in the final analysis by a "strongman," i.e. the corporate raider. (It should go without saying that these political metaphors are just that; in a free market all transactions are voluntary exchanges of property.) Consequently, if CEOs and other members of upper management make incredibly

high earnings year after year, it must be that the shareholders find their services worth the expense. In some cases it may take the outside analyst some effort to discover *how*, but we shouldn't doubt that the shareholders are careful with their money.


Unfortunately, I cannot close the analysis on this optimistic note. For the above relies on the assumption of a free market in corporate takeovers, and that is decidedly lacking. In the present legal and cultural environment, so-called corporate raiders are even more despised than golden-parachuting CEOs. Regulations severely restrict so-called hostile takeovers, and hence hamper the ability of shareholders to restrain their managers. For example, the federal Williams Act (1968) compels a would-be raider to declare his intentions after

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acquiring 5 percent of a corporation's shares. Declaring one's intention to take over a company would likely push up the stock price, making the takeover plan unfeasible.

The market's other checks on inefficient management are stifled as well. After all, even before the financial innovations allowing the issue of "junk bonds" and hostile takeovers, there was always a sure-fire way to keep corporate officers in line: any firm that wasted too much money on fancy offices and executive perks would be vulnerable to its competitors. Again, this initially poses a puzzle for critics such as Crowley; if outrageous compensation for CEOs is so endemic in American corporate culture, why don't new firms enter these industries and drive the old ones out of business?

But as with hostile takeovers, so too with new entrants to industry: Government regulation muffles this

threat and thus allows entrenched businesses a margin of profligacy that they otherwise would not enjoy. Many people (especially young students) new to the ideas of laissez faire believe that big business opposes government meddling, but this is naïve and contradicted by the history of actual legislation. Ironically, the profitability of big business can actually be *enhanced* when the government regulates an industry, because the big firms can more easily handle the fixed costs of filling out paperwork, providing a "safe" working environment, proving that they are making every effort to comply with affirmative action goals, and so on. In this environment, would-be competitors face additional hurdles if they want to challenge the large incumbents, and thus the latter may indeed get away with lavish expenditures that would be short-lived in a truly free market. 

In the opinion of the demagogues inequality in what they call the "distribution" of wealth and incomes is in itself the worst of all evils. Justice would require an equal distribution. It is therefore both fair and expedient to confiscate the surplus of the rich or at least a considerable part of it and to give it to those who own less. This philosophy tacitly presupposes that such a policy will not impair the total quantity produced. But even if this were true, the amount added to the average man's buying power would be much smaller than extravagant popular illusions assume. In fact the luxury of the rich absorbs only a slight fraction of the nation's total consumption. The much greater part of the rich men's incomes is not spent for consumption, but saved and invested. It is precisely this that accounts for the accumulation of their great fortunes. If the funds which the successful businessmen would have ploughed back into productive employments are used by the state for current expenditure or given to people who consume them, the further accumulation of capital is slowed down or entirely stopped. Then there is no longer any question of economic improvement, technological progress, and a trend toward higher average standards of living.

—Ludwig von Mises, "Inequality of Wealth and Incomes"