The Real Problem with Executive Pay

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What's the one thing that Hillary Clinton and Donald Trump have in common? This sounds like a trick question – but it isn't. Like almost every politician in the world, from Theresa May to Jeremy Corbyn to Xi Jinping and Angela Merkel, they think executive pay is too high.

The numbers appear shocking. In the US, the average S&P 500 CEO earned $14m in 2007, 361 times the average worker; and that's gone up from a ratio of 42 in 1980. In the UK, the median FTSE 100 CEO earned £4m in 2017, 137 times the median worker. How can this be justified? It's hard to argue that CEOs are more talented than in the past.

But it's instead because talent has become more important, due to the rise in firm size. A CEO's actions are scalable. For example, if she improves corporate culture, this can be rolled out firm-wide, and thus has a larger effect in a larger firm. If culture adds 1% to firm value, that's £10m million in a £1 billion firm, but £90 million in a £9 billion firm – the current median firm size in the FTSE 100. Suddenly, her £4m salary doesn't seem so outrageous. This argument doesn't apply to employees because their actions are less scalable. An engineer who has the capacity to service 10 machines creates £50,000 of value regardless of whether the firm has 100 or 900 machines.

Indeed, pay has risen in almost every scalable profession. The pay of footballers, authors, musicians, and even reality TV stars has skyrocketed even faster than CEO pay. Even though they're not clearly more talented than in the past (e.g. footballer Alexis Sanchez vs. Johan Cruyff, or author JK Rowling vs. Jane Austen), they now have a global audience. This also means that, to solve inequality, governments should cast their net much more widely than CEOs, and address high income from all professions – perhaps with a higher tax rate on incomes above £1 million.

But even if pay levels are right on average, the way we structure pay may be wrong. As economists Michael Jensen and Kevin Murphy famously wrote, "it's not how much you pay, but how." Does CEO pay hold them accountable for long-term performance?

Many studies claim that the answer is no, and they've been widely quoted by critics of CEO pay. But whether we trust a study should depend not only whether we like the findings but whether they're rigorous. None of these studies are published in top peer-reviewed journals because they have a fatal flaw: they only consider changes in the CEO's pay and ignore how much of her wealth is tied up in the company. Steve Jobs was paid $1 per year regardless of performance, but he had $2 billion of his wealth invested in Apple.

But is pay sensitive to the right performance? This is where I believe the real problem with executive pay lies. Most current pay structures for executives involve "Long-Term Incentive Plans", which are complex structures linking the CEO's bonus to several targets. Despite the name, they encourage short-term behaviour to hit the target. If the CEO only gets a bonus if profits hit £1 billion, and they're forecast to be just under, she may cut investment or wages. Indeed, a large-scale study finds that this behaviour systematically happens. (Interestingly, CEOs don't use share buybacks to hit profit targets, despite common concerns).

So what's the remedy? To scrap complex bonuses and replace them with simple long-term shares. This removes incentives to hit arbitrary short-term targets. Evidence finds that, in the long-run, the stock price takes into account not just shareholder value, but several measures of stakeholder value. In my TEDx talk "The Social Responsibility of Business", I show that companies that treat their workers well beat their peers on long-term stock price performance.

But the key words are "in the long-run". Just like bonuses, giving the CEO shares can encourage short-termism if she's allowed to sell them early. Angelo Mozilo, the former CEO of Countrywide Financial, wrote sub-prime loans to pump up the stock price. He then sold $129 million of shares when he quit, avoiding Countrywide's 70% stock price fall when the loans went delinquent in the financial crisis. Another study found that CEOs cut investment when they are about to sell their shares. So a CEO's shares should be locked up for the long-term. Indeed, the new UK Corporate Governance Code extends the lock-up from three to five years. Some companies, where investments have particularly long-term payoffs, should go even further.

Cutting pay levels may win headlines, but it's changes in the structure of pay – making it simple and long-term – that will create a fairer and more sustainable society.