**Are CEOs Paid Too Much?**

BY DAVID VAN DEN BERG

In June, President Obama announced the appointment of a Washington attorney as the administration’s new “special master” for executive compensation. Kenneth Feinberg, the appointee, will oversee pay packages of company executives whose firms are receiving government assistance. Feinberg will review and approve any compensation for the senior executives and the next 20 highest-paid employees at seven firms who received money through the Federal Government’s TARP program. Those companies include Bank of America, Citigroup, AIG, General Motors, GMAC, Chrysler, and Chrysler Financial, according to the Treasury Department. Feinberg’s duties also include advising 8 more financial companies that received government money about executive pay.

Part of the debate in Washington about executive pay has centered on the question of whether CEOs are overpaid relative to their contribution to firm value. Another question has revolved around whether their compensation packages create incentives for them to take excessive risks. Across the corporate sector, the size of executive compensation packages has soared. The gap between the salaries of the workers and the CEO of a corporation has widened considerably. In 1982, the ratio of median CEO pay to median production worker pay was 90 to 1, according to a Congressional Research Service report. In 2005, that ratio had increased to 579 to 1. Even executive compensation packages often contain multiple elements. CEOs can receive company stock, stock options, deferred compensation, long-term bonuses, and nonmone- tary perks. Not all of these new stock options have been an important element of CEO pay since the 1950s, although executives receive those more frequently now.

In a 2008 paper, New York University economists Xavier Gabaix and Augusta Landier write: "The sixfold increase in U.S. CEO pay between 1980 and 2003 can be fully attributed to the sixfold increase in market capitalization of large companies.” Gabaix says that this suggests the market for CEOs works well and there are only a few egregious examples of executives getting paid more than they would expect based on their contributions to a company’s success. CEOs may operate in a kind of superstar market, which the late University of Chicago labor economist Sherwin Rosen describes as in which "relatively small numbers of people earn enormous amounts of money and dominate the activities in which they engage." The differences in talent levels among top executives is quite small, Gabaix and Landier argue. However, those small differences can lead to big gaps in compensation and are magnified by firm size. In their paper, they note that the first CEO on the list earns over 100 percent more than the 498th ranked executive.

The more-talented CEOs seem to add more value to their companies than the less-talented ones. Marko Tervio of the University of California at Berkeley tried to determine what would happen if the managers of the 1,000 largest U.S. companies in 2004 had been replaced by less-skilled executives, such as the CEO of the company at the bottom of the list. The combined market value of the top firms would have been perhaps $12 billion lower. Tervio’s calculations imply talented CEOs contributed $7 million to $12 billion, or 15 percent of the total market value, of the largest 5,000 firms. Anant Anant and Jason Jauregui in a 2008 paper for the Richmond Fed’s Economic Quarterly.

Economists differ on how clearly the executive’s pay should be linked to the company’s performance. For instance, stock options may prove problematic in CEO compensation packages, Gabaix says, by encouraging exces- sive risk taking that only temporarily bolsters a firm’s share price. In addition, a large decline in share price can render the stock options worthless and granting new options or re-pricing existing ones may seem to reward an executive for failure.

Part of the CEO’s compensation should not be subject to risk, providing some insurance against bad performance due to factors outside of his or her control. Jauregui writes. Failure to compensate for risk that assurance would make it difficult to recruit executives.

In a May 2009 paper, Gabaix and three co-authors propose one possible solution for improving incentive structures. They suggest awarding executive pay through “dramatic incentive accounts.” Under the plan, CEOs would see their pay escrowed each year and would have no immediate access to most of it. A constant percentage of an executive’s pay would be invested in company stock and the remainder in cash. The portfolio would be continuously rebalanced so that an increasing portion of the executive’s wealth is sufficient to induce effort at minimum risk to the executive. The executive would receive small portions of the account gradually, and that gradual vesting would continue even after an execu- tive’s departure. This could discourage an executive from behaving badly, such as using accounting tricks to inflate the company’s short-run stock price before cashing out and leaving the firm in shambles.

In the end, structuring executive compensation in a way that aligns the incentives of the CEO with those of the company and its shareholders can be a tricky task but one crucial to well-functioning markets.

**What Prolonged the Great Depression?**

BY MATTHEW CONNER

The right to host a mega-event such as the Olympics or the World Cup is seen as an honor to the nation to the private sector that sufficient to induce effort at minimum risk to the executive. The executive would receive small portions of the account gradually, and that gradual vesting would continue even after an executive’s departure. This could discourage an executive from behaving badly, such as using accounting tricks to inflate the company’s short-run stock price before cashing out and leaving the firm in shambles.

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While most economists would argue that the main cause of the Great Depression was unwise mone- tary policies, such policies alone cannot adequately explain the severity and duration of the crisis. In this paper, Ellen McGrattan of the Minneapolis Fed seeks to prove that some fiscal policies during the period had more than a small impact. One key insight of the paper is that prior studies on this topic have assumed that the only sort of capital taxed during this period was profit. Yet the big change in policy was actually a substantial increase in the taxation of dividends in the Revenue Act of 1932.

As McGrattan suggests, even the anticipation of divi- dends taxation — a proposal publicly suggested by President Herbert Hoover as early as 1930 — could have had an effect on investment in that period. In addition, the studies that suggest tax increases had little or no effect note that few people actually paid income taxes during this period. McGrattan notes that while this is true, the taxpayers who did pay those taxes earned almost all of their income through dividends.

Adding dividend taxation to the standard growth model on which the majority of research on this topic is based, McGrattan discovers that a large fraction of the observed decline in productivity between 1929 and 1932 is explained by her tax-inclusive model. Additionally, the decline in produc- tion hours per capita during this period also can be explained by her model.


The research shows that Olympic host countries have seen up to a 30 percent increase in exports. Yet the main authors also find an almost equal increase in trade in the nations that vied for the right to host the event but were not chosen. This implies that the effect on trade comes not from actually hosting the games but from bidding for them in the first place.

The authors speculate that this increase results from the signal that bidding to host the event sends to the world. This “signaling strategy” conveys the country’s interest in trade liberalization. This idea is illustrated by the fact that just two months after being awarded the right to host the 2008 Summer Games in July 2001, China successfully concluded negotiations with the WTO, thus formalizing its commitment to trade liberalization.

"Subprime Mortgage Pricing: The Impact of Race, Ethnicity, and Gender on the Cost of Borrowing." Andrew Houghsaw, Christopher Mayer, and Joseph Tracy, Federal Reserve Bank of New York Staff Report 368, April 2009.

Some have argued that during the peak period for sub- prime lending (2004 to 2006) minority borrowers were saddled with higher interest rates than nonminority borrowers. The authors of this study test that claim, using a new sample that merges data on more than 75,000 adjustable rate mortgages with information on the race, ethnicity, and gender of the borrower. They find that even controlling for an array of factors, the authors actually received slightly lower rates. Black and Hispanic borrowers paid a slightly lower initial mortgage rate than other borrowers, although Asian borrowers paid a slightly higher rate. No appreciable differences were found in lending terms based on gender. Finally, the adjustable rates on the mortgages did not “reset” at higher levels for minority borrowers relative to nonminority borrowers when one controls for risk and location. The authors conclude that these results suggest the possibility that subprime lend- ing was a credit innovation that did serve as a positive credit supply shock in locations with more minority residents.

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