Are CEOs Paid Too Much?

POLICY UPDATE

I n June, President Obama announced the appointment of a Washington attorney as the administration’s new “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 employe es 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 80 more financial companies that received government support 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 1980, 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 179 to 1. Even compensation packages often contain multiple elements. CEOs can receive company stock, stock options, deferred compensation, long-term bonuses, and noneconomic benefits. Not all of these are 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 Augustin 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 one 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 two hundred percent more than the 99th percent 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 $2 billion lower. Tervio’s calculations imply talented CEOs contributed $7 million to $2 billion, or 15 percent of the total market value, of the largest 1,000 firms. Ananta R. Jhaque in a 2008 paper for the Richmond Fed’s Economic Quarterly. Economists differ on how closely 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 excessive 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 control. Jacque writes. Failure to base compensation on performance 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 “dynamic 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 the executive’s pay would be invested in company stock and the remainder in cash. The portfolio would be continuously rebalanced so that the stock fund 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 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. 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. "Capital Taxation During the U.S. Great Depression." Ellen R. McGrattan, Federal Reserve Bank of Minneapolis Working Paper 676, April 2009.

What Prolonged the Great Depression?

AROUND THE FED

W hile most economists would argue that the main cause of the Great Depression was inadequate mone tary policy, 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 dividend 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 declines in GDP between 1929 and 1933 is explained by her tax-inclusive model. Additionally, the decline in production hours per capita during this period also can be explained by her model.

A Subprime Mortgage Pricing: The Impact of Race, Ethnicity, and Gender on the Cost of Borrowing.” Andrew Haughwout, 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 subprime 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 57,000 adjustable rate mortgages with information on the race, ethnicity, and gender of the borrowers. To test the hypothesis, they examine the differences in mortgage lending while controlling for both the risk profile of the mortgage and the characteristics of the neighborhood in which the property was located.

In contrast to some previous findings, their results show that there is no evidence of adverse pricing for most mortgages. The authors of this study note that the findings could be due to the fact that fewer countries are able to host that event) The authors also found a strong positive effect on trade from other mega-events such as the Olympics. The research shows that Olympic host countries have seen up to a 30 percent increase in exports. Yet the 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.

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