Is Ford CEO Alan Mulally Overpaid?

CBS MoneyWatch
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March 23, 2011

United Auto Workers President Bob King is not happy with the $54.5 million compensation package Ford Motors CEO Alan Mulally is receiving for his performance at the company.

Is this level of pay justified? One argument in favor of high CEO pay is that it creates the correct incentives for upper management. If pay depends upon performance of the firm, and there is a lot riding on performance, then the CEO will do everything possible to ensure the firm does well.

But theory does not always translate into practice, and high CEO pay may cause performance to get worse rather than better. A recent paper by Lucian Bebchuk, Martijn Cremers and Urs Peyer found that the pay slice of CEOs has been increasing over time, and CEOs receive a larger fraction of the total pay of the top four executives than they did in the past. However:

- Firms with a higher CEO pay slice generate lower value for their investors. Relative to their industry peers, such firms have lower market capitalization for a given book value.
- Firms with a high CEO pay slice are associated with lower profitability.

Why does high CEO pay lead to lower profitability, and hence lower shareholder value? They identify four causes that are generally associated with governance problems:

- Firms where the CEO has a large pay slice tend to make worse acquisition decisions.
- Firms with a high CEO pay slice are more likely to reward CEOs for “luck.” That is, they are more likely to increase CEO pay when the industry as a whole does well for reasons that are unrelated to the CEO’s own performance. This is generally a sign of governance problems.
- Higher CEO pay slice is associated with weaker accountability for poor performance, reflecting less willingness on the part of directors to discipline the CEO.
- Firms with a higher CEO pay slice are more likely to provide their CEO with option grants that can be opportunistically timed. Such “lucky” timing is often due to the use of insider information or the backdating of option grants.

As they note, this does not mean that “every firm with a high CEO pay slice has governance problems, much less that such firms would necessarily be made better off by lowering it.” But high CEO pay may still “signal governance problems that might not otherwise be readily visible. Investors and corporate boards would thus do well to pay close attention not only to the compensation captured by the firms’ top executives, but also to how this compensation is divided among them.”

This research suggests that pay is excessive, but it speaks more to the distribution of pay among top executives — watch out when it’s skewed toward the CEO — than it does the level of pay. Is there any evidence beyond this that the amount of pay received by top executives is excessive? How can we tell if pay is excessive?
In theory, when markets are working optimally, anyone involved in the production of a product should receive a wage equal to their marginal contribution to the bottom line. For example, if a worker and manager can make 2 goods an hour that can be sold for $10 each, then they are worth $20 per hour to the firm. If the worker’s contribution is $8, and the manager’s $12, then they should be paid those amounts.

The question, then, is whether CEOs are, on average, paid an amount that reflects their productivity. One way to answer this is to look at CEOs in other countries running similar companies and see how pay compares. As noted in the Economist, “For companies with sales over $11 billion, American bosses earn nine times more, and European ones four times more” than bosses in Japan. Even if American bosses are somehow exceptional, it’s unlikely they are this much better than their foreign counterparts. That is, it’s extremely unlikely that differences in productivity can explain the cross-country differences in pay. There is something besides productivity that determines these differences.

In addition, as noted here, executives at firms such as Bear Stearns and Lehman actually made money even though the firms had huge losses from the financial crisis. This disconnect between shareholder fortunes and the fortunes of executives is further evidence of a disconnect between CEO compensation and productivity.

CEOs make hundreds of times what a typical employee makes and the share of income that CEOs receive has been increasing over time. If this is due to their high and increasing productivity, and if the high rate of compensation gives CEOs the correct incentives, then we shouldn’t be too concerned. However, while CEOs are expensive and we should expect to pay them high salaries, current compensation levels do not provide the correct incentives — if anything high compensation results in worse outcomes — and the compensation levels exceed the amount that can be justified by CEO productivity. (For good, non-technical discussion of CEO pay reform by Lucian Bebchuk of Harvard Law School, see here, here, and here.) The specifics of each case are different, but the general claim that CEO pay is excessive is hard (though not impossible) to rebut.

**Update:** I also meant to talk about the broader economic implications of excessive CEO pay. The main problem, and this has as much to do with the structure of pay as it does with the level, is that the CEO may be induced to maximize short-run gains and then cash out even if it comes at the expense of the company’s long-run fortunes. The problem is that the pursuit of short-run gains can induce CEOs to take on excessive risk, even more so when the downside is limited, and this can pose systemic risks for the economy.