EXECUTIVE SUMMARY

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The Truth about CEO and Worker Compensation

by Vincent Geloso

In recent years, there has been a concern that CEO pay has been out of step with the pay of the average worker. This concern has been fueled by a belief that CEO pay is not linked with performance and that corporate executives are shielded in their jobs. This study is meant to dispel myths about CEO compensation in Canada and provide some much-needed nuance. The analysis uses improved approaches to data to provide a correct depiction of the differences between the compensation of CEOs and that of the average worker and the factors driving the compensation offered to CEOs.

First, CEO pay has increased because the demand for the skills of CEOs has increased. With rapid technological changes and globalization, firms have been exposed by more intense competition. In such settings, even small errors can be costly. The skills needed to lead a major corporation are thus increasingly valued, which means that there is great (and increasing) demand for such skills. The economics, economic history, and management literature confirms this by showing that the average CEO today tends to have more technical skills than in the past. This literature also shows that boards invest considerable resources in selecting the right candidates, tracking the performance of those selected, and firing those who fail to perform. Indeed, between 38% and 55% of CEO turnovers are "performance-induced" (that is, the CEO is fired for disappointing performance). This explains why we find high turnover at the top. Consider the top 100 CEOs in Canada in 2007. Of those who were in those top slots in 2007, only 15 remained in 2017. To put things in perspective, the turnover among the top 100 in Canada is nearly twice as fast as in the United States.

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Second, an important caveat about CEO pay. Boards select the managers of corporations based on the ability to generate profits, not the manner in which those profits are generated. Thus, if political factors enter into consideration for maximizing profits, and especially if these factors overtake market-based considerations, CEO pay will be conditioned on political clout. This is a crucial nuance. The literature on economic inequality makes clear that people are unconcerned with unequal distributions as long as they are perceived as fair (that is, that people have reasonable chances at upward economic mobility). This being the case, when industries walled from competition by government regulations and/or subsidies offer high pay to politically connected managers, one can easily understand the discontent. However, in such an instance, the discontent ought to be directed at the perversion of incentives that political meddling in market processes generate. This is a nuance that is too rarely heard.

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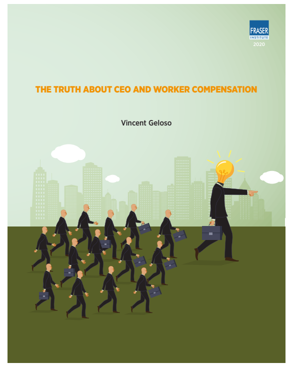
Third, studies comparing CEO to worker pay are flawed. They compare apples to oranges, for example, the overall compensation of top 100 CEOs with the cash pay of all workers. An apples-to-apples comparison that consists in comparing the overall compensation of these top 100 CEOs with the total compensation of the workers in companies of equal size to those managed by these CEOs is better. Such a comparison reduces the ratio frequently published by 24%. An even better comparison consists in comparing the top 1,000 CEOs to the average worker. When this is done, instead of comparing workers to the arbitrarily defined top 100, the ratio of CEO to worker compensation falls by 81%. The best comparison consists in comparing all senior management workers with all workers. When this is done, the ratio between the pay of managers and that of workers falls from 197:1 to between 1.75:1 and 2.1:1—a considerably lower figure.



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